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FED SHADOW

The Fed's Bond Boo-Boo

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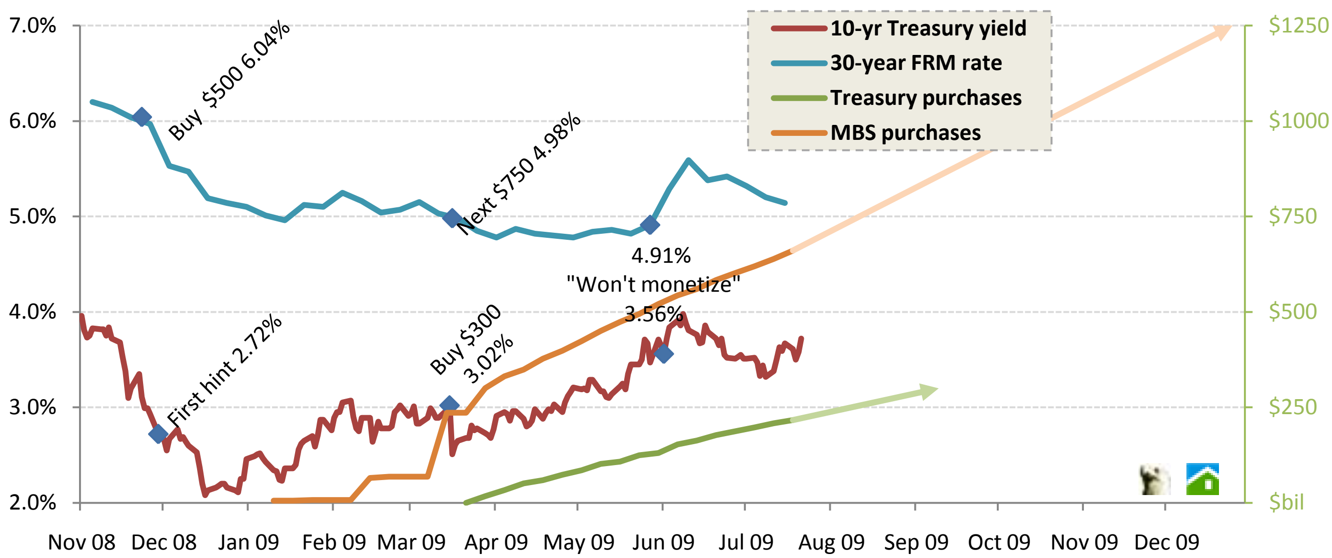
The FOMC knows its $300 billion bond buy was a mistake -- it won't be buying more.

Update to strategic view
US BONDS: The Fed now regrets its panicked decision to buy $300 billion long-term Treasury bonds. It will complete the program, but if long yields rise in the face of expanding supply and diminishing safe-haven demand, the Fed will only expand its acquisitions under very narrow circumstances. The Fed's next move in bonds is more likely to be to sell them. This shifts the balance of risks decisively in favor of selling or shorting long-term Treasuries.
[see Investment Strategy Dashboard]

We believe that there has been significant evolution in the way the Fed views its program to acquire $300 billion in long-term Treasury bonds. This evolution has important consequences for how the Fed will react to changes in yields, and how it will manage its "exit strategy" from its extraordinarily large balance sheet. In short, according to highly placed sources, the FOMC now unanimously regards its March 18 decision to acquire Treasury bonds to have been a mistake made in a moment of panic, a mistake that produced much difficulty and no demonstrable benefit. That said, the Fed is nearly certain to complete the acquisition program -- with only $83 billion left to buy, there is little to be gained in exchange for losing credibility by failing to follow through on an announced commitment. But the Fed is highly unlikely to expand the acquisition program, even in the face



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of sharply rising long yields. And whenever the Fed becomes willing to signal the beginning of the pro-active reduction of its balance sheet, the Treasury bond position will likely be the first to go.

The idea of buying Treasury bonds for the Fed's balance sheet evolved through a series of shifting rationales. It was first floated in a speech by Ben Bernanke early last December, rationalized as simply to "influence the yields on these securities, thus helping to spur aggregate demand." The decision to commit to buying $300 billion in Treasuries came at the FOMC meeting of March 18. The post-meeting statement gave the rationale as "to help improve conditions in private credit markets." The minutes of that meeting rationalized it yet another way: "Such purchases would provide further monetary stimulus to help address the very weak economic outlook and reduce the risk that inflation could persist for a time below rates that best foster longer-term economic growth and price stability."

Rationales aside, according to sources, the FOMC simply panicked. With stock prices having collapsed following Barack Obama's inauguration (see "Quantum of No Solace" March 10, 2009), and with the Geithner Treasury seemingly enjoying no credibility whatsoever in its attempt to rescue the banking system (see "Number of the Beast" March 18, 2009), the Fed felt it was the only agent of authority capable of instilling confidence -- so it opted to make the grandest possible gesture (see "Ben Boldly Goes" March 19, 2009). At the same time as it announced the $300 billion Treasury acquisition program, it also announced the $750 billion expansion of its $500 billion agency MBS program and the $100 billion expansion of its $100 billion agency obligation program.

But in that FOMC meeting, the purchase of long-term Treasuries was especially controversial -- producing dissension only barely hinted at in the minutes. One FOMC member objected aggressively, arguing that

- the lack of a coherent rationale for it would rattle markets,
- that it would likely not have any useful impact on the massive Treasury market,
- that it would bloat the Fed's balance sheet,
- and that if would destroy confidence by raising the specter of the Fed's outright monetization of debt.

In the spirit of comity he relented without formal dissent, but his objections have proven to be correct.

- As Treasury yields rose abruptly to 4% last month, markets had no idea whether the Fed would buy more bonds to turn yields back (see "No, Mr. Bond, I Expect You to Die" May 22, 2009), or for that matter, if yields were to *fall*, whether the Fed would *still* buy bonds to restore confidence, though doing so would drive yields even lower.
- If the original idea was to keep yields low to stimulate aggregate demand, then the acquisition program has utterly failed -- after a sharp drop on the day of the announcement, yields went right back to where they were before, and well beyond (see the chart on the first page of this report). Mortgage rates didn't improve either -- their drop from above 6% late last year all came in the wake of the initial announcement of the Fed's program to acquire agency MBS.
- The issue of the Fed's huge balance sheet has become such a flash-point that Ben Bernanke has had to write an op-ed in the *Wall Street Journal* to explain what he's going to do about it (see "Check the Exit" July 22, 2009).

- And the disturbing issue of monetization came into the market's consciousness immediately -- we ourselves raised it the very next day (again see "Ben Boldly Goes"), and Bernanke found himself in the embarrassing position of having to deny it to his antagonists in Congress (see "They Laughed When I Sat Down to Monetize" June 4, 2009).

The best thing that can be said about the Treasury acquisition program is that, since its inception, the economy and the credit markets have improved. But, according to sources, nobody on the FOMC attributes that to the Treasury acquisition program itself. The proof is that, last month, when the 10-year yield moved to 4% with the economy regarded by most observers to still be in recession -- and it seemed for a while as though the Treasury wasn't going to be able to successfully auction its supply -- the Fed *didn't intervene* by announcing it would buy more bonds. Indeed, why should it? The first $300 billion had no impact on yields, so why should the second $300 billion be any different. Except that it may have had the unintended consequence we outlined (again, see "No, Mr. Bond, I Expect You to Die"), that by aggravating inflation expectations through outright monetization, it could perversely drive yields higher in the attempt to make them lower.

According to sources, in the face of another run higher in long yields, the Fed would only intervene under very particular circumstances. If Bernanke judged that the move in yields was due to rising inflation expectations, or heightened concern about the creditworthiness of the Treasury, or legitimate recognition that the economy was strengthening, then the Fed would stand by and do nothing. It would *only* intervene in the exceptional case that Bernanke judged that the move was due to *excessively optimistic* perceptions of economic strength, at strong variance with actual economic weakness.

All this considerably changes our view on Treasury bonds. We have long argued that as the credit crisis recedes, as safe-haven demand evaporates, and as the Treasury's relentless supply increases, yields are destined to move much higher. But our expectation that the Fed would intervene to cap yields has kept us from arguing in favor of selling or shorting (see, among many others, "Treasuries: Too Late to Buy, But Too Early to Sell" January 16, 2009). We suppose we were correct to the extent that, by announcing the acquisition program in March, the Fed did in fact intervene. Our error was in thinking that the Fed would intervene *again*, and this caused us to miss the move in yields from the secondary low established the day the Fed's acquisition program was announced.

Now, our dominant expectation for the Fed's intervention in the bond market is that it will be a *seller*, not a buyer. If it regrets its acquisition of Treasuries, then when the time finally comes when it judges is makes sense to wind down its enormous balance sheet, selling them will be a natural first step. And just because their *buy* program had no *downward* effect on yields, it can't be casually assumed their *sell* program won't have any *upward* effect. Until proven otherwise, the prospect of the Fed being a seller has to add to the bear case, at least at the margin.

With the 10-year yield now at 3.7%, we can't be as enthusiastic as we ought to have been when they were at 2.5%. But the case against bonds is fundamentally intact. Cutting against it is the near-record steepness of the yield curve, which makes the opportunity cost of selling bonds (or the cost of carry to short them) considerable. And with what we expect to be a sluggish and jobless recovery, riskless assets will remain a somewhat attractive parking place even if they are no longer needed as a safe haven. But with the Fed no longer a buyer -- indeed, with the Fed a likely seller -- bonds no longer have the Fed on their side. In fact, they're fighting the Fed.

BOTTOM LINE: The Fed now regrets its panicked decision to buy $300 billion long-term Treasury bonds. It will complete the program, but if long yields rise in the face of expanding supply and diminishing safe-haven demand, the Fed will only expand its acquisitions under very narrow circumstances. The Fed's next move in bonds is more likely to be to sell them. This shifts the balance of risks decisively in favor of selling or shorting long-term Treasuries.