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Fed moving (slowly) towards the exit

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For professional investors

Key points

- Bernanke explains Fed exit strategy
- Several new instruments will be deployed
- No rate hikes any time soon

During the financial crisis, the Fed has introduced a whole range of unorthodox measures to prevent an outright economic depression. Many of these measures have already been terminated, but an enormous amount of liquidity has remained in the banking system. As banks have been reluctant to lend these funds and households have been preoccupied with paying down debt in stead of borrowing, banks have stalled most of their reserves at the Fed. This poses two problems. First of all, if the economic recovery would prove to be sustainable, which we don't expect, credit growth could accelerate quickly and inflation could emerge. Secondly, activity in the interbank market has slowed, making the official Fed funds rate a less reliable indicator of the stance of monetary policy. Fed-president Bernanke was set to testify on these issues before Congress on 10 February, but congressman decided to take the day off to play in the abundant snow. As Bernanke's testimony was released on paper, we could read how his exit strategy looks like.

The Fed's new instruments

The Fed has several instruments to prevent the mountain of liquidity igniting inflation. First of all, the Fed could pay interest on the reserves. This would put a floor under interbank rates, as banks would not lend at lower rates than those at which it could stall money at the Fed. It also makes reserves placed at the Fed marginally more attractive and would therefore discourage banks to lend the money elsewhere. A slight problem is that Fannie Mae and Freddie Mac would not be paid interest by the Fed and could thus drive rates lower than those paid by the Fed. Thus, the Fed could introduce time deposits to effectively lock up reserves for a specific period.

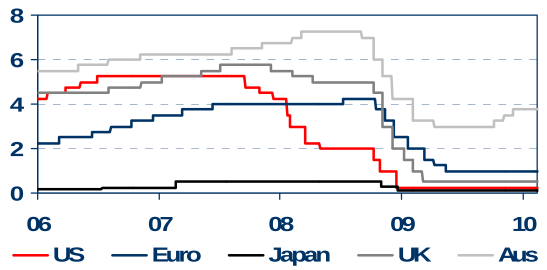
Another second instrument would be reverse repos. In this case the Fed would temporary sell securities to the banks, draining liquidity from the system. The Fed has already experimented with this instrument on a small scale to test its feasibility. Bernanke also mentioned a wider spread between the Fed funds rate and the discount rate. Banks can always borrow at the Fed against the discount rate, which therefore caps interbank rates. The spread was lowered during the financial crisis from 100 to 25 basis points. Thus, the rate paid on reserves and the discount rate would effectively provide a corridor for interbank rates. Interestingly, Bernanke played down the importance of the Fed funds rate due to the lower activity in the interbank market. Was this to take the heat off the debate on rate hikes?

Finally, the Fed could sell the assets it purchased during the crisis. However, this looks highly unlikely for the time being. Although one Fed official has argued for an early termination of the Fed's program to buy mortgage-backed securities, the majority view at the Fed appears to be that the program will be terminated in March and that the Fed will stand ready to resume if necessary. The fact is that nobody really knows to what extend the program has lowered the yields on these securities and actual mortgage rates. Thus, nobody knows if or how far yields will rise when the program is ended. Selling these securities is certainly a bridge too far for the time being.

No hikes soon

How does this affect the outlook? To us it's clear that official rates will not be hiked in the US, the eurozone or the UK for quite a few months. The Fed must first assess how the end of the MBS purchased program will affect the housing market and the overall economy. Furthermore, the bank can deploy the other instruments first. Indeed, Bernanke repeated in his testimony that rates will be exceptionally low for an extended period.

Official interest rates



Source: Datastream Fortis Investments

The ECB is faced with severe fiscal problems and weak economies in several peripheral countries. The ECB has the possibility to reduce liquidity in the banking system by not rolling over current loans. As many loans will not mature before the summer, this will be a gradual process. The Bank of England has ended its purchases of Gilts, but governor King was decidedly bearish on the economy recently and would not exclude renewed buying of Gilts if necessary. The aftermath of the financial crisis is not over yet. Just last week the Financial Times reported on problems in CDO markets resulting from the Lehman default. This cast doubts over the future of structured finance. Also last week the Congressional Oversight Panel, which is responsible for reviewing the Treasury's USD 700 billion bailout program, said commercial loan losses next year up to USD 300 billion could jeopardize the stability of many banks, particularly the nation's midsize and smaller banks, contributing to prolonged weakness throughout the economy

Conclusion

In our outlook 2010 we highlighted the risk that monetary authorities would get their timing on a change in policy wrong. Their historic record is not encouraging. Too early tightening would kill the recovery, while waiting too long would lead to inflation. However, the cautious and inventive approach by central banks may have reduced this risk. We think monetary policy is broadly neutral for equities. Yes, rates are low, but credit to the private sector remains weak and central banks are moving slowly towards the exit.

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