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Fixed-Income Insights

The Fed Steers QE into Uncharted Waters

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Zane Brown, *Partner, Fixed Income Strategist*

After months of suggesting that it would deliver another round of monetary stimulus, the U.S. Federal Reserve rewrote the central banking playbook with a quantitative easing (QE) program that is seemingly unlimited in terms of its amount and scope.

In announcing the new program, the Fed appears to have firmly set its sights on the stubbornly high U.S. unemployment rate of 8.1% as of August 2012. While there had been anticipation that a new policy would be open-ended in terms of amount, the scope of what the Fed has set forth is potentially an all-encompassing proposal. Indeed, the Fed suggested that if the labor market does not show signs of significant improvement, "the [Federal Open Market] Committee will continue its purchases of agency mortgage-backed securities [MBS], undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability."

The undefined nature of the additional asset purchases and use of other policy tools gives the impression that the Fed will do whatever it deems necessary to lower the unemployment rate. And although it provided some guidelines for the amount of asset purchases through the end of the year, the notion that it could undertake additional steps means that these amounts might also be open-ended.

In terms of the amount guidelines, the Fed said it will purchase an additional $40 billion in agency MBS per month. This latest initiative, which is scheduled to begin immediately, will be conducted in conjunction with the Fed's extension of Operation Twist and its reinvestment of principal payments from agency securities. In all, the additional asset purchases will increase the Fed's long-term securities holdings by $85 billion per month through the end of the year. Finally, the Fed said that it anticipates exceptionally low levels of the fed funds rate until at least mid-2015, which is an extension of its previous pledge that was through at least late 2014.

Considering the open-ended nature of the latest program, it is unclear if the Fed will explicitly announce changes to its policies. Although the Fed has pledged to improve its transparency, if these changes are not explicitly announced, investors could get a sense of any shift by watching for changes in the size and composition of the Fed's balance sheet, particularly in 2013.

In addition to the open-ended tone of the statement, it contained a couple of other notable segments. The first item of note should surely catch the attention of those concerned about how further loosening of monetary policy will affect the rate of inflation. Indeed, in what was a change from previous statements, the Fed said that it expects that a highly accommodative monetary policy will be appropriate for a "considerable time" after the economic recovery strengthens. This implies that even if economic growth accelerates, and possibly with faster inflation, the Fed is poised to maintain its accommodative stance.

This fits with a second change in tone because the Fed is clearly targeting the labor market. In prior quantitative easing programs, the Fed seemed to focus on the ability of the programs to lower long-term interest rates. The latest policy statement, however, seems to emphasize the potential stability of long-term interest rates well into the future. This stability may give confidence to potential homebuyers, business owners, and other entities reliant on financing that interest rates should not interfere with their plans. And the Fed may hope that any activity from potential homeowners, businesses, and others could eventually have a positive effect on the labor market.

The timing of the latest program will likely raise some eyebrows because it comes shortly before a tightly contested presidential election. Yet, the Fed stated the move was prompted by concerns that “without further policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions.” This comes as the prospects for future fiscal stimulus are slim, regardless of the outcome of the presidential election.

As far as capital market implications, the Fed’s latest initiative continues the theme of moving into “risk-on” assets. In addition to the prospect that these securities may perform well with the additional open-ended stimulus, the latest policy might mean that securities with less credit risk, such as Treasuries and agency MBS, could post negative real returns, considering that their yields may be below the rate of inflation.

For corporate borrowers, the Fed’s additional securities purchases should continue to provide attractive financing opportunities in the bond and loan markets. Over the past few years, these opportunities have allowed many companies to refinance existing debt and extend debt maturities, which provides some explanation as to why defaults in the high-yield bond market are expected to end 2012 at 1.5%, well below the long-term average of about 4%.[1] Even with these solid fundamentals, high-yield credit spreads were above their long-term averages as of early September 2012.[2]

As suggested, the latest Fed program also could add to investors’ concerns about accelerating inflation. If this is the case, they may want to add some inflation protection that is focused on the movement in consumer prices, without the additional risks that may come from movement in interest rates or volatility in the commodities markets.

Now that the latest stimulus has arrived, an important question for many investors—and the Fed—will be whether open-ended quantitative easing can have an economic impact beyond fueling further gains in risk-on assets. For some perspective on this issue, investors may want to closely watch conditions in the labor market, considering the Fed’s frequent reiteration of its mandate to foster maximum employment.

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[1] J.P. Morgan Credit Strategy Weekly Update, September 7, 2012.

[2] Credit spread data are based on the J.P. Morgan Global High Yield Index, which is designed to represent the universe of U.S. dollar global high yield corporate debt, including domestic and international issues.

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