



# Adams Hall

Asset Management

On March 18, the Fed announced a bold move to expand its balance sheet by buying mortgage-related securities and Treasuries. Here are some thoughts on the Fed's massive plan:

## **Actions and reactions**

- The Fed announced plans to buy an additional \$750 billion in agency mortgage backed securities, \$100 billion in agency debt, and, most notably, \$300 billion worth of longer-term U.S. Treasury bonds.
- In recent months, Fed officials had floated the idea of buying long-term Treasuries to reduce long-term interest rates, but the announcement of an actual plan to do so took markets by surprise.
- In reaction, the yield on 10-year Treasuries fell by almost 0.5 percentage points –the biggest one-day decline since the 1987 stock market crash. Encouragingly, mortgage interest rates also declined, pushing the rate on 30-year fixed rate mortgages well below its recent 5% level.
- The U.S. dollar, by contrast, fell very sharply reflecting the potential inflationary impact of such an expansionary monetary policy, while gold prices soared also presumably in response to inflation fears.
- Relative to the bond and currency markets, stocks had a more muted response, with the S&P 500 rising by about 2%.

## **Supply, demand and the bond market**

While the Fed has achieved some initial success in pushing long-term rates down, it is unlikely to make it stick.

If the Fed and the Administration are successful, the U.S. economy should resume a path of economic growth in the next year, with core inflation returning to a normal 2% or so. Over the past 40 years, the 10-year yield has averaged about 2.8 percentage points above core inflation. Given the massive increase expected in the supply of Treasury debt, this “real” yield may well be a little higher than average over the next few years, pushing nominal 10-year Treasury yields to 5%. This being the case, why would private investors, be they from Beijing or Buffalo, be willing to accept a 2.5% yield on those bonds today?

Some might, for as long as the recession is deepening, but any hint of an economic turnaround ought to lead to a whole-scale dumping of Treasuries. And, with normal mortgage spreads, this could boost 30-year fixed rate mortgage rates to somewhere between 6% and 7%. This wouldn't be an economic disaster. Nobody today is hesitating to buy a house because mortgage rates are

just too high, and even mortgage rates between 6% and 7% would still be extraordinarily low by historical standards.

But as Alan Greenspan used to say, the law of supply and demand has not been repealed, and regardless of its intentions, the Federal Reserve should not be able to sustain today's low Treasury or mortgage rates, once the economy shows any solid signs of stabilizing.

### **Supply, demand and inflation**

If the Treasury market reacted too positively to the Fed's announcement, the currency and gold markets may well have reacted too negatively. Inflation hawks are concerned about the huge expansion in the money supply implied by the Fed's actions as well as the equally mammoth federal budget deficit.

However, neither of these forces should lead to inflation in the short run. Again, supply and demand come into play. The U.S. economy is suffering from massive oversupply.

- Twelve and a half million workers are looking for a job – nearly twice as many as two years ago.
- We are using just 71% of our industrial capacity – the lowest level in 26 years.
- Inventories of houses and cars still seem plentiful relative to current sales.

If Washington is successful in generating extra demand, competitive forces should translate this demand into higher output rather than higher prices. Inflation only becomes an issue when extra demand meets a lack of supply and sellers finally have the bargaining power to raise prices.

This is where time is on the Fed's side. We often sprint into recession, but meander into expansion. Even the blockbuster expansion of the 1980s took six years to cut the unemployment rate from 10.8% down to 5%.

The Federal Reserve has a printing press, and right now, they are cranking it up. But they also have an incinerator to destroy excess money when it is no longer needed. During the next long expansion, they will have plenty of time to sell Treasuries and other securities back to the public, mopping up excess money supply. With this in mind, and provided they are as disciplined in removing monetary stimulus as they have been bold in adding it, the upcoming expansion should be as benign in terms of inflation as each of the last three.

The bottom line for investors is, despite the drama in the Fed's announcement, it probably justifies neither the best hopes of the bond market nor the worst fears of the currency markets. For once, the stock market, in a modest advance, may have gotten it right, reflecting a small short-term positive for the economy with only limited inflation downside.

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