<u>EXIT STRATEGIES: THE FED, US TREASURIES, AND US STOCKS</u>

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In the film "The Great Escape" (John Sturges, director), Ramsey, an Allied POW in a WW2 German prison camp, declares: "Colonel Von Luger, it is the sworn duty of all officers to try to escape."

MARKETPLACE EXITS

Does the Federal Reserve Board have a coherent detailed exit plan from its long-running extraordinary and highly accommodative monetary policy? No. Is it likely to devise one soon? No. Is it nevertheless likely to continue to stress its ability to prudently manufacture and implement a suitable exit program? Yes.

The Fed's broad and unspecific principles do not create a genuine and practical exit strategy. Neither do fervent hymns proclaiming devotion to its legislative mandate. Neither does rhetoric about studying numerous, intertwining, changing, and complex variables and eloquence regarding its diligent monitoring of the economic landscape. Adherence to forward guidance wordplay is not an adequate substitute for a practical strategy. The Fed's policy exit generally will be reactive, with its decisions and actions that of a follower rather than a leader.

Why does the Fed battle to create expectations that it has, or at least can and (when necessary) readily will develop, a suitable exit program? The central bank wants audiences to have faith that it can substantially influence the creation of desirable economic outcomes. Exit guidelines fortify marketplace and political hopes that a vigilant, wise, and sufficiently experienced Fed really (or at least very probably) knows how and when it can retreat gracefully from its glorious easy money programs without endangering United States (and worldwide) economic growth and the central bank's inflation and employment targets.

The Fed's quest to create confidence in its exit strategy also fights to promote confidence that American interest rates will not rise too far or too fast. Why fear a bear move in debt securities? Higher rates would weigh on economic growth. They would wound owners of US Treasury and other debt securities, which could inspire many "investors" to flee from these marketplaces (especially from longer-dated debt). Such escapes of course could lead to even higher yields. Besides, why risk sitting around awaiting capital loss when the Fed promises higher rates- unless such hikes occur very slowly and with sufficient warning? Given the huge foreign ownership of US Treasury securities, net foreign selling (or even reduced net buying) of them could make funding of the nation's budget deficits increasingly difficult (especially in later years), particularly as the Fed soon will no longer be ravenously buying US Treasuries.

Moreover, the Fed also does not want a sharp sustained bear tumble in the US stock marketplace. The enormous stock bull move has helped to rebuild household net worth and sparked rises in consumer and business confidence and activity. After the Fed ended the first two rounds of money printing, the S+P 500 dropped. The gradual tapering of its current mammoth debt securities acquisition adventure underlines its fears of another run to the exits by stock owning audiences.

THE FED: TALKING THE (EXIT) TALK

Everyone I know, everywhere I go
People need some reason to believe". "Running on Empty", a Jackson Browne song

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The Fed's very slow tapering of its current quantitative easing (money printing) binge and its long-running refusal to raise the Federal Funds rate to compensate for inflation suggest that the US and worldwide recovery stands on much shakier ground than the Fed publicly admits.

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The Federal Reserve Board has steadfastly maintained the Federal Funds rate at the rock-bottom range of zero to .25 percent since December 2008. Over the past several years, the guardian has embarked upon massive rounds of note and bond purchasing (quantitative easing). Yet despite that lengthy passage of time, what evidence has it provided indicating that it has figured out how to escape from the confines of its yield repression scheme and bloated balance sheet?

The Fed indeed for a few years has tried to convey the impression that it has good ideas on, or at least readily can create, a fine exit plan. The Minutes of the Federal Reserve Board's June 2011 meeting proclaimed a framework of principles for an exit strategy from its extraordinary and highly accommodative monetary policy. Two years later (Federal Open Market Committee's Minutes, 4/30-5/1/13), this watchdog noted the Fed's June 2011's overview proposed "broad [exit strategy] principles along with some details about the timing and sequence of specific steps". Comments on "broad" concepts and principles and "some details" unfortunately still do not much "clarify how it intended to normalize the stance and conduct of monetary policy when doing so eventually became appropriate". The Fed, though it believed "The broad principles adopted almost two years ago appeared generally still valid", murmured about explaining or revising those principles at some future time.

Has the Fed more recently offered more significant enlightenment? Not really. Despite the passage of three years since the June 2011 Minutes, the revered central banker offers only a vague picture as to how and when it will raise interest rates. The June 17-18, 2014 FOMC Minutes hint at 2015 as an appropriate year for tightening on the rate front (see Figure 2 in the "Summary of Economic Projections"). However, that viewpoint is merely a current implicit conjecture derived from the views of a majority of FOMC participants. That year consequently is not fixed as definite current policy; besides, the Projections do not even indicate when (as in which calendar month or quarter) in 2015 a rate rise will enter the scene. Maintaining the current Federal Funds level for a "considerable time" after the asset purchase program ends is not terribly precise. In any case, the current target range for the Federal Funds rate depends on indefinite notions of "progress", both "realized and expected", toward its two percent inflation and maximum employment objectives (FOMC Statement).

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The Fed probably will not offer significant insight into its exit strategy anytime soon. After all, its current debt securities acquisition festival is an entrance program, not an exit one. A tapering of an entrance program means that the money printing entrance still continues. The Fed tapering still has several months to run. As of July 2014, Fed purchases are at a $15 billion per month rate for agency mortgage-backed securities and $20 billion per month for US Treasuries. The Fed probably will announce the ending of tapering following its October 2014 meeting. The Fed congregates 7/29-30/14, 9/16-17, 10/28-29, and 12/16-17.

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Look further into the June 2014 Minutes (see pp2-4). The Fed surely has faith in its amazing policy toolkit, but in regards to an exit strategy the Fed is more of a talker than a doer. In this gathering of economic sages, "participants continued their discussion of issues" connected to "eventual normalization", with the staff presentation including "some possible strategies" for implementing and communicating monetary policy". Are "some possible strategies" signs of a genuine program in place or nearly so? Note "outlined design features" of a "potential" overnight reverse repurchase facility. Term deposits and term reverse repurchase agreements were discussed. The Committee discussed "options" regarding its policy of rolling over maturing Treasury securities at auction and reinvesting principal payments on agency debt and agency mortgage-backed securities in agency MBS. Should reinvestments end before the first firming in policy rates, as indicated in the June 2011 principles? There was no consensus. No agreement was reached regarding adjustments on interest rates for excess reserves.

In addition, the policy for handling Fed Funds during normalization now has become murky. Here again the Fed, rather than demonstrating an authentic definite (or even fairly definite) exit strategy, is tinkering with alternative ideas and possible actions. We learn that "most participants" believed the Federal Funds rate "should continue to play a role" during normalization. But only "many" (not most) indicated a preference for continuing with a Fed Funds target range. Yet "a few" believed a focus on an administered rate "might" be preferable in communicating the policy stance. See also the Financial Times (7/11/14, p1): "Fed eyes makeover for key funds rate".

The FOMC participants unsurprisingly "generally expressed a preference for a simple and clear approach to normalization that would facilitate communication to the public and enhance the credibility of monetary policy." Unfortunately, they clearly do not have such a "simple and clear approach". Underline their comment: "it would be useful for the Committee to develop and communicate its plans to the public later this year, well before the first steps in normalizing policy becomes appropriate."

It looks like any Fed exit plan will occur on a piecemeal basis as time passes. The Fed and its apostles may label this exit approach as prudent, reasonable, appropriate, and flexible, right? In any event, the Minutes note most of the FOMC "expect to learn more about the effects of the Committee's various policy tools as normalization proceeds". Thus they can develop and change methods and their application as they proceed. "Many" participants "favored maintaining flexibility about the normalization process as well as the Committee's long longer-run operating framework."

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The Fed's June 2014 Minutes do not enlighten financial congregations as to how and when the bank will genuinely and significantly slash the size of its gigantic balance sheet. However, a recent speech by President Dudley of the New York Fed (he also is a FOMC member) offers some interesting comments ("The Economic Outlook and Implications for Monetary Policy"; 5/20/14). He underlined that a key June 2011 exit principle still applies. So changes in short term rates will be the primary method of adjusting monetary policy post-liftoff, "not discretionary changes in the balance sheet. In other words, the balance sheet will be set on automatic pilot."

However, Dudley underscores that the June 2011 policy regarding sales of agency mortgage-backed securities no longer applies. Citing Chairman Bernanke's June 2013 Press Conference following the FOMC meeting, Dudley said "outright agency MBS sales are no longer contemplated during the process of monetary policy normalization." He noted: "The balance sheet would shrink post lift-off as Treasury securities matured and mortgages were prepaid". However, one also should ask if the Fed will sell any of its Treasury securities as part of the normalization program.

Yet Dudley and the Fed do not mention another aspect of this balance sheet management with UST and MBS. Suppose the balance sheet, presumably on "automatic pilot", "shrinks" (via money sent back to the Treasury, probably). This shrinkage does not cause money creatively printed from various quantitative easing rounds to be withdrawn from the marketplace. After all, the way to permanently withdraw that money from the marketplace is the opposite of quantitative easing. It would require outright sales of UST or mortgage-backed securities (a reverse repurchase agreement is not a means to permanently withdraw funds). Thus a Fed unwillingness to sell mortgage-backed securities (or UST) makes permanent the Fed's inflationary quantitative easing actions. Since such so-called "normalization" of the Fed's balance sheet apparently does not undo its money printing, there eventually may turn out to be significantly more inflation over the so-called long run than the Fed now anticipates.

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Former Fed Chairman Bernanke emphasized that the Fed's monitoring of the financial system is "ongoing". The Fed leader assured marketplace dwellers: "In light of the current low interest rate environment, we are watching particularly closely for instances of 'reaching for yield' and other forms of excessive risk taking, which may affect asset prices and their relationships with fundamentals." (Speech, "Monitoring the Financial System", 5/10/13).

The Fed devotedly continues its monitoring; for example, see recent Minutes as well as Chairman Yellen's recent address, "Monetary Policy and Financial Stability" (7/2/14). The Fed apparently does not see systemic dangerous bubbles, excessive euphoria, or irrational exuberance. Although the Chairman sees "pockets of increased risk-taking across the financial system" (low levels of corporate bond spreads and expected volatility in some asset marketplaces; easy credit terms in the leveraged loan sector), she seems watchful rather than fearful. Therefore the Fed does not need to hurry to normalize its policy in the near term.

However, the Bank for International Settlements warns about financial risks ("Annual Report", 6/29/14). A NYTimes article recently headlined "From Stocks to Farmland, All's Booming, or Bubbling", "Prices for Nearly All Assets Around World Are High, Bringing Economic Risks" (7/8/14, ppA1, B6). Is or will the Fed be guilty of "irrational complacency" in regard to such phenomena?

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Why be surprised that the Federal Reserve currently displays little evidence of a coherent, detailed, practical plan for a substantial reversal of its epic easing? Recall the end of the Goldilocks Era and the dismal times of 2007-2008/early 2009. The Fed did not have an adequate (comprehensive, detailed) entrance strategy as the US and international economic disaster emerged and began to worsen either. It only developed a suitable rescue and repair program after the crisis accelerated significantly.

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The Fed has not stood alone among central banks on the financial battlefield. The European Central Bank, Bank of England, Bank of Japan, China's central bank, and others have in various fashions embraced easy money policies. What will their exit principles be?

SEARCHING FOR SAFETY: EXITING THE UST MARKETPLACE

The Fed is not the only financial visionary with an exit strategy. Participants in debt, stock, currency, commodity, real estate, and other marketplaces also possess exit (and entrance) schemes and tactics. Nowadays, the marketplace views, plans, and actions of many of these financial pilgrims probably are influenced substantially by the Federal Reserve's exit strategy talk and maneuvers.

Noteworthy inflation increases (or fears regarding this), or imminent or actual Fed tightening, might induce a widespread exodus from ownership of US debt securities by wary, weary, or money-losing holders. A vague Fed exit strategy, short on specifics and timing, at least up to some point can help the Fed to inspire many owners of American interest rate securities and stocks (use the S+P 500 as a benchmark) to postpone substantial marketplaces exits from their positions.

A recent Financial Times article suggests Fed concern about a rush to the exits by debt owners. In reference to the corporate bond marketplace, Fed "officials have discussed whether regulators should impose exit fees on bond funds to avert a potential run by investors" (6/17/14, p1). The article implies that the corporate debt talked about was American. The article does not mention a Fed concern regarding funds of US Treasury securities. However, US corporate rate trends link to UST ones; and UST movements intertwine with rate and stock marketplace movements around the world. Anyway, a fund focused on US Treasury debt can see its investors run for the hills too.

What if foreign government rates (or overseas corporate debt yields) ascend significantly, perhaps on the European periphery or in an important emerging marketplace? There could be flight from funds holding foreign sovereign or corporate debt as well.

A separate FT article indicates that given the substantial amount of emerging marketplace debt issuance in the past few years, some observers around the globe increasingly worry regarding a scramble out of those securities (Financial Times, 6/22/14, p22).

The Fed can trap UST yields at low levels more readily than it can American corporate marketplace ones. Thus those corporate yields- whether in junk bonds, mortgage-backed securities, or elsewhere- may keep marching higher for a while even if the Fed successfully blocks or slows the UST curve's efforts to climb.

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The short end of the UST yield curve, depending on the time to maturity, currently offers negative or little nominal return relative to inflation. Picture the two year note, for example, at around .5 percent with inflation measures of 1.5pc or more. To give UST owners a real return, what should UST yields be (on both the short and long ends of the yield curve) if inflation creeps up to (or beyond) the Fed's target around two percent?

Although a conspicuous yield boost trend by itself does not categorically show that there has been "net selling" (involving a significant exit by existing owners), it may reflect this. At any rate, notable yield climbs can alert observers of a growing reluctance by existing holders to stay in place (or to add to their positions) or an increasing unwillingness of potential buyers to join the ownership fraternity.

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Past and upcoming federal US deficit totals and trends obviously influence the total of UST securities outstanding and readily available for purchase ("free supply"). So does the extent of the Federal Reserve Board appetite for UST. Yet tapering probably will end fairly soon. All else equal, reduced demand for UST by the Fed will tend to boost UST yields. And although the Fed has not yet created a genuine coherent exit strategy, it eventually plans to normalize its highly accommodative monetary policy. Overseas institutions- including both central banks and the private sector- own a massive amount of UST. Thus foreign activity in the UST marketplace is extremely important to UST yield (and related debt, stock, and currency) trends. How pleased will foreigners be if UST rates rise from current levels? How will they respond to the Fed's exit strategy as it develops? Much will depend on not only on the extent and speed of rate increases, but also on US inflation levels and dollar trends.

The United States Treasury reports on a monthly basis net foreign purchases of UST notes and bonds. Though the government releases these on a lagged basis, they offer insight into past and potential overseas behavior. Over the course of long run history, the overall foreign owner group sometimes has escaped from its UST holdings, becoming a net seller. What does a snapshot of recent history regarding net foreign UST trading reveal? Even though these players generally have been net buyers of UST, they are not imprisoned in that marketplace.

Major foreign holders of US Treasury securities (bills, notes, and bonds) own a total of about $5.96 trillion of them at end April 2014, up about $251bb from April 2013. Foreign official holdings represent about 68.2pc of this; 91.0pc of the overseas ownership is in notes and bonds. (US Treasury data, 6/16/14; next release 7/16/14).

Who are the largest holders by far? Mainland China owns about $1.26 trillion, with Japan grasping about $1.21 trillion. Individual country data does not separate official and private (general public) ownership totals.

Even if foreigners are not net sellers, their rate of net buying may decrease (even if federal deficits remain rather lofty). Average net buying of UST notes and bonds in calendar 2009 was about $44.9 billion per month, with that in 2010 $58.6bb per month. Net foreign purchases of these instruments in calendar 2011 slipped to $36.0bb per month, with calendar 2012's just over $34,7bb.

However, calendar 2013's net foreign purchases of UST notes and bonds tumbled to merely $3.6bb per month. Several months in first half 2013 saw significant net selling; net foreign buying of UST should not be taken for granted. For the 10 months from July 2013 through April 2014, net buying was about $19.3bb/month (about $232bb net acquisition if annualized).

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The Fed's UST buying plan pursuant to quantitative easing helped to finance the US government budget deficit. Since the Fed plans to wind down its money printing program, viewers should monitor budget deficit sizes and trends after tapering ends. Will foreign sources or US individuals and institutions increase their acquisitions once the Fed completes its tapering process?

Federal fiscal year (October 1 through September 30) 2013 had an actual budget deficit of $680bb, 4.1 percent of GDP (Congressional Budget Office, "Updated Budget Projections: 2014 to 2024", Table 1; April 2014). Compare 2009's 9.8pc budget deficit. The CBO forecasts fiscal 2014's deficit will slip to $492bb (2.8pc of GDP), with 2015's edging down to $469bb (2.6pc of GDP). Thereafter, however, deficits begin to expand, up to $627bb (3.0pc of GDP) in 2018 and around $1.0 trillion in the years 2022 to 2024 (3.7pc of GDP deficit or higher for each of these three years).

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The US national political scene is gridlocked, with a Democratic President and Senate confronting a Republican House. This logjam probably will continue after the fall 2014 elections.

President Obama is in office until 2016; regardless of what happens in the Senate, the House probably will remain Republican after 2014's poll. How eager will people be to own UST if fierce quarrels in Washington resume over discretionary spending levels or increases in the debt ceiling?

RUNNING FOR COVER: US STOCKS

The Fed's very easy money policies played a crucial role in the commencement, sustaining, and extent of the major bull move in US stocks that began in March 2009. If yields are unattractive in the US Treasury marketplace (especially at the short end), why not hunt for return (yield) in US stocks (and lower grade interest rate instruments such as junk bonds)? Of course numerous other variables such as stock earnings, share buybacks, government spending, inflation, US dollar strength or weakness, and commodity prices influence S+P 500 price levels and trends.

The Fed has left the quantitative easing stage twice before. In each case, from roughly around the time of the end of the securities buying program, the S+P 500 tumbled. The Fed ended QE1 in March 2010. The S+P 500 established a high at 1220 on 4/26/10, falling about 17.1 percent to 7/1/10's 1011 low. QE2 ceased in June 2011. The S+P 500 made an interim top at 1371 on 5/2/11, diving 21.6pc to 1075. Compare the Fed's exit from QE this time around. Its departure has been very gradual, probably in part due to fears about precipitating a significant stock price drop; it announced the first round of tapering on 12/18/13, with the fifth reduction revealed 6/18/14. Will stock marketplace investors run for cover more or less around the time the Fed completes its tapering process?

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