FEDERAL RESERVE EXIT STRATEGIES
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"Don't believe the hype", raps the group Public Enemy in their song by that name.

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CONCLUSION

Federal Reserve Board generals have underlined that they indeed possess an exit strategy for their ongoing extraordinary easing program. Such confident rhetoric regarding an escape plan indeed helps to boost the morale of many economic and political observers of marketplace battlefields. Didn't its entrance strategy work? The Fed Funds rate has stayed near the ground floor since late 2008, United States Treasury yields have collapsed relative to their 2007 heights, and US equities (use the S+P 500 as a signpost) have soared from their March 2009 abyss.

Yet marketplace combatants should be wary of the Fed's exit strategy design as well as its tactical implementation. It is not a detailed and finished blueprint. In actual practice, the exit strategy involves significant risk, and it probably will not be put into practice nearly as timely or smoothly as propaganda from the Fed leadership hints. How rapid, coherent, and helpful were the Fed's policy viewpoints and actions in the early stages of the worldwide economic crisis? As the Fed's marketplace entrance strategy and maneuvers were very remarkable and evolved over time, why should its exit plan and its application be any more "orderly"?

Of course numerous variables influence US government (and other interest rate) yields and the levels and trends of stock benchmarks such as the S+P 500 (and many other "assets" such as real estate and commodities). Yet why should the Fed's exit strategy be without some significant pain to UST and stock owners? There's at least a significant risk of notable wounds. After all, the rally in debt and equity prices assisted by the Fed's massive marketplace easing generally enriched and thus pleased owners of American stocks and UST (and many other debt instruments). Besides, we know the noble Fed is not the only significant policy maker and fighter on the US (and international) economic battlefield. Thus its practical control over marketplace outcomes has significant limits.

RATE REPRESSION AND MONEY PRINTING

The Federal Reserve obviously is not the only big gun in central banking. And it certainly has not been the only major central bank pursuing highly accommodative policies since late 2008/early 2009. Also, massive deficit spending by the United States, as well as by many other key nations around the globe, has helped to spur economic growth. But since the Fed plays a crucial role in the American and thus the worldwide economic scene, survey several key aspects of what's been happening in and from the Fed's campaigns over the past several years.

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At the sunset of the Goldilocks Era and roughly three months before the S+P 500's 10/11/07 major top at 1576, the Federal Funds rate stood at 5.25 percent (monthly average, Fed H.15 statistics). As the worldwide financial crisis worsened, the Fed captains hustled to slash rates. By December 2008, Fed Funds not only had cratered deeply and fallen under one percent (the 2003 valley, in the aftermath of the last bout of significant US economic weakness). They rested at rock bottom levels, beneath .25pc. Despite some inflation since then (even if generally less than two percent), the Federal Reserve's yield repression policy has persisted over four years. The

trusty watchdog continues to bark loudly and repeatedly that in pursuing its mandate, it anticipates the pinning of the Funds rate near the floor will persist for quite some time. (See the FOMC January 2013 decision). This very low rate policy thereby assists the Fed's fervent quest to rebuild the consumer balance sheet and assist debtors in general.

The Fed's iron grip on the Federal Funds rate has played a major part in crushing yields on US Treasury securities. The US two year note has tumbled to and remained around .25 percent; the 10 year note reached a depth of about 1.40pc in summer 2012, with the 30 year UST beaten down to 2.50pc. It thereby has encouraged financial scouts to hunt for yield ("return") in other debt territories (such as corporate and emerging marketplace bonds), as well as in stock marketplaces and alternative "investment" fields such as commodities.

In its effort to help ignite and sustain economic recovery and bolster consumer and corporate (and political) confidence, the Federal Reserve's awesome money printing strategy (via the purchase of US Treasury and mortgage-backed securities) has intertwined with its yield repression one. Money printing obviously is not the only variable influencing price levels and trends. But all else equal, quantitative easing tends to boost nominal prices of goods, services, and "assets", including stock and commodity domains.

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The militant Fed's extraordinary money printing performance has rocketed America's monetary base upward. For the two weeks ending February 6 2012, the base hovered around $2.8 trillion. Thus it has more than tripled since August 2008, around when the global economic crisis accelerated. (See the Fed's H.3).

The Fed, though it now worries about insufficient inflation (and deflation), often dutifully proclaims that it remains vigilant in regard to signs of excessive inflation. It captivatingly asserts that long run inflation expectations have remained modest and well-anchored. Indeed consumer prices and personal consumption expenditure statistics have appeared benign. And money supply is not the only variable influencing inflation levels and expectations. Nevertheless, substantial money supply growth over time is not unimportant to inflation and interest rate yields.

Gigantic Fed money printing probably has assisted money supply growth. According to the Fed's H.6 (2/14/13), M1 ballooned (seasonally adjusted annual rate) 11.8 percent in the 12 months from January 2012 to January 2013, expanding 6.7pc in the three months to January 2013. What about M2? That measure climbed 7.5pc over that 12 month period, advancing 7.7pc in the most recent three months. As for currency in circulation, the year-on-year jump through mid-February 2013 is about 7.5 percent (Fed H.4.1, Table 1). These percentages are well above the Fed's two percent long run inflationary target. Is this sustained money supply growth a warning sign of a ticking time bomb for inflation?

Now focus on the Federal Reserve's balance sheet. For the week ending 2/13/13 (H.4.1, Table 1), the Fed sheriff held outright $2,776,889 million ($2.8 trillion) in debt securities. These include $1.72 trillion in US Treasuries and about $980 billion in mortgage-backed securities.

The $2.8 trillion represents about 17.7 percent of US nominal GDP around $15.8 trillion (fourth quarter 2012, seasonally adjusted annual rate; Bureau of Economic Analysis, 1/30/13). The UST holdings alone represent about 10.9pc of nominal GDP. The Fed, even before the financial crisis and its going on the warpath with its very accommodative debt purchasing program, kept UST on its books as part of its policy management weaponry. Yet the Fed's current hoard of debt securities- including that of UST in particular- is substantial relative to GDP. That it has taken

several years to accumulate these debt securities underlines the size of these Fed holdings and the difficult challenge the Fed faces in disposing of a large number of them.

United States government (Treasury) marketable debt outstanding held by the public is about $11.1 trillion. Broken down, this is $1.6tr in bills, $7.4tr in notes, and over $1.4tr in bonds, with nearly .9tr in inflation-protected securities ("Monthly Statement of the Public Debt", 1/31/13). This equals about 70.2pc of GDP. US governmental accounts hold an additional $4.9tr in Treasuries.

According to the Treasury International Capital (TIC) report, (2/15/13), major foreign holders of Treasury securities at end December 2012 owned $5555.4 billion (about $5.6 trillion) worth. Thus foreigners own a lion's share- around fifty percent- of the publicly outstanding US federal debt securities. The December 2011 total was $5007bb. Moreover, their end 2012 UST inventory stash represents about 35.1 percent of US GDP. At end December 2012, noteworthy UST possessors included Mainland China with $1.2tr, Japan $1.1tr, oil exporters $262bb, and Brazil with $252bb. Of the overall total, foreign official holdings equaled $4007bb (about 90 percent of which were Treasury notes and bonds), so the overseas public owned over $1.5tr.

THE FED'S GRAND EXIT PLAN

The Federal Reserve's fierce as well as sustained easing policies such as yield repression and money printing represent a glorious and determined entrance to and stay within the economic battlefield. But the Fed (and its central banking cohorts elsewhere) if there's a marvelous entrance strategy, surely there must possess an amazing strategy of retreat that it will implement prudently when "things get better"? Surely bullet-dodging financial warriors on Wall Street and Main Street, as well as fearful political platoons around the world, should not be kept in suspense on this score. As part of its fight to build and maintain faith in the majesty and wisdom of its economic vision and easing programs- and to promote belief that it can at least substantially influence many economic outcomes in the desired fashion without undue, unnecessary, and unfortunate bloodshed- the Fed has unveiled a grand exit plan.

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The June 21-22, 2011 Federal Reserve Open Market Committee Minutes herald and summarize the Fed's exit methods and their probable sequence ("Exit Strategy Principles"). This bulletin states the "key elements of the strategy they expect to follow when it becomes appropriate to begin normalizing the stance and conduct of monetary policy."
http://www.federalreserve.gov/monetarypolicy/fomcminutes20110622.htm
Related to this procedure, review the Fed's "Credit and Liquidity Programs and the Balance Sheet" in the "Longer-term issues" section (last updated 10/31/12).
http://www.federalreserve.gov/monetarypolicy/bst_longerterm.htm

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Ceasing to reinvest principal payments on securities holdings, modifying forward guidance on the path of the Federal Funds rate, and temporary reserve-draining operations will alert marketplace sentinels of the Fed's shifting ground. However, such activity probably will be less dramatic than the announcement of and actual march toward a higher Federal Funds level (range). Watch the changing interest rate on excess reserves and the reserve level in the banking system. Thereafter, the Fed may elect to sell some of its mountain of securities (after advance warning to the public, and allegedly at a "relatively gradual and steady pace").

Especially in regard to the importance of the Fed's rather specific unemployment and inflation guidelines linked to its exit strategy, as well as that navigator's determination to remain flexible, remember recent Fed policy broadsides. Note the FOMC's December 2012 statement
http://www.federalreserve.gov/newsevents/press/monetary/20121212a.htm
and Chairman Bernanke's related (12/12/12) Press Conference.
http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20121212.pdf
See too the FOMC Press Release of 1/30/13 (and its Minutes, released 2/20/13).
http://www.federalreserve.gov/newsevents/press/monetary/20130130a.htm
http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20130130.pdf

In the transcript of "Chairman Bernanke's Press Conference" (12/12/12, p14): "My anticipation is that the removal of accommodation after the takeoff point, whenever that occurs, will be gradual." His comment on how the Fed in practice will normalize its balance sheet over time is rather vague, despite reference to a strengthening economy consideration (see p18).

In any event, the Fed generals currently do not want to call a ceasefire to their highly accommodative easing. The Fed's 1/30/13 Press Release again trumpets: "the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens."

The Fed's next meeting is March 19-20, 2013. It then meets April 30-May 1 and June 18-19, 2013.

FED STAGECRAFT, EXIT OUTCOMES

"All the world's a stage,
And all the men and women merely players:
They have their exits and their entrances..." Shakespeare, "As You Like It", Act II, Scene vii

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Over some notion of the long run, the Fed intends to preserve the triumphs achieved thus far by of its extraordinarily accommodative easing entrance and performance. In its long-running war seeking to achieve desirable economic results, the Federal Reserve wants to avoid marketplace ambushes. The Fed obviously does not have substantial control over US budget deficit policies and conflicts. What about the world's currency wars (competitive devaluation strife)? Fed interest rate and money printing policies are not only the factor influencing US dollar weakness (or strength). The guardian Fed nevertheless does not want to appear negligent to the audience it seeks to persuade with its charming talk. The fusillade of Fed eloquence regarding having a prepared and well-designed exit plan (with plenty of ammunition) partly reflects its desire to appear prudent and substantially on top (ahead) of an admittedly changing and allegedly (at times) unclear economic (political) vista.

Just because the Fed has armed itself with a theoretical exit strategy, this does not guarantee the Fed leaders will be able to implement it as they desire.

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As suggested above, even though some inflation measures remain unthreatening, substantial money supply growth warns that the Fed's perception on longer run and maybe even current inflation arguably is overly optimistic.

Consider in this vein some lines in the recent address by the President of the St. Louis Fed, James Bullard. ("U.S. Monetary Policy: Easier Than You Think It Is; 2/14/13). He says (p17): "Worries about rising inflation have so far been unfounded." Should one underline the "so far", particularly as he then declares: "However, QE2 did change inflation and inflation expectations"? http://research.stlouisfed.org/econ/bullard/pdf/BullardStarkville14Feb2013final.pdf

The Fed surely remains a determined enemy of the evil "excessive inflation".

Yet given sustained yield repression and money printing, might there be some signs of significant inflationary winds blowing within asset marketplaces (even if not yet from measures such as the consumer price index)? Might repression in one place assist bloating (or "bubbles" and maybe even the famed so-called "irrational exuberance") in another location? How concerned are the Fed and other central banks regarding inflation signs from stock marketplaces such as the S+P 500? The S+P 500 has more than doubled since its March 2009 valley and has edged toward its 2007 (and 2000) pinnacles. US (and worldwide) economic recovery and stronger corporate earnings indeed have helped the rally, but to what extent have the blessings of equity gains (and recovery and earnings) derived from very generous accommodative money policies in the US and elsewhere?

The rally in the US equity arena (and several related ones) should be interpreted alongside some other phenomena, including the "investment" quest for yield (return). Spy out some recent news comments. "A roaring trade in emerging market bonds has triggered fears an EM debt bubble is inflating." (Financial Times, 2/5/13, p21). In a story regarding "exotic securities", the Financial Times (2/9/13, p1) states: "Sales of securitizations such as asset-backed securities and collateralized loan obligations are now at a post-crisis high, as investors seek out higher-yielding securities." What about some other stock marketplaces than the more traditional ones of advanced OECD nations? "Investors start a new scramble for Africa" headlines the Financial Times (2/8/13, p19). In speaking of "frontier markets", "It's the ultimate in risk versus return. Hunters of investment exotica are heading to Africa, where some of the world's riskiest [stock] markets are now enjoying big gains." The FT speaks of other alluring countries, not just African ones, in this article. And the NY Times headlines that even a Federal Reserve Governor, Jeremy Stein, "Raises the Specter of a Bubble in Junk Bonds" (2/8/13, pB2).

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Fed wordplay on exit strategies may boost confidence inside the Fed's walls and outside in US interest rate, stock, and other marketplace trenches. But how easy will it be in practice for Fed engineers to reverse their loose policies without a rather rapid race to the exits by many holders of UST? What about a run to the exit door by owners of and many other sovereign and corporate debt securities bound up with (related to, influenced by) UST? After all, why hold debt securities (particularly those with long maturities) if you think rates will advance (or leap) higher?

Chairman Bernanke confesses in his December 2012 FOMC Press Conference (p18): "as the exit comes closer for the Federal Reserve, then you would expect longer-term bond yields to begin to rise." One also should ask the Fed how easy it will be to lift the Federal Funds rate slowly (gradually) if public net buying of UST diminishes significantly (or turns into net selling).

Suppose American inflation is two percent (or higher). Where should the UST yield curve be to give owners sufficient real return? Assume Federal Funds (and related) rate increases stand out as likely. Then even if such debt owners do not become net sellers, they may well reduce their net buying. What's the bottom line? Many current UST owners may not want to peacefully absorb more (at least for now) debt on their books if they perceive the Fed will push rates higher.

Moreover, some may not want to suffer or risk damage to their portfolio, so they may embark on their own exit strategy to get ahead of the Fed's. In such scenarios, how easy will it then be for the US to finance gaping holes in its federal deficits (especially those looming ominously over the long term)? To attract capital, it may well have to pay higher interest rates.

Underscore in this context the massive size of the Fed's debt securities inventory (even allowing for a supposedly slow rate of liquidation). How easy will it be to dispose of this without some bloodshed? After all, it took a few years to build that inventory up.

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In general, despite the attractiveness of UST to those with flight to quality (safe haven) fears, and though a large supply of UST may be needed to satisfy worldwide demand for high-quality collateral, both domestic players and foreigners are hostile to negative (or very low) real returns on their US Treasury holdings.

The topic of currency wars and competitive devaluations has captured much attention in recent months. However, all else equal, and though of course what other economic and political players around the world say and do matters, the Fed's sustained yield repression policy tends to weaken the broad real trade-weighted dollar (TWD). How eager will many foreigners be to keep holding UST if real yields are mediocre, and especially if the TWD slumps from around current rather weak levels. It was 83.1 in January 2013 (monthly average), close to the July 2011's 80.5 record depth). Not only the TWD, but also US dollar cross rates with key nations also matter for this analysis.

Admittedly the official sector owns most of the overseas holdings of UST securities. The US dollar is a key reserve currency. But that does not prove the foreign official squadrons inevitably will continue to add to their UST holdings, or that they will not liquidate some of them. Besides, foreign commercial institutions and individuals may be less likely to treasure their UST holdings than the official clans.

At some point, the Fed might be forced to boost interest rates faster than it might like to protect the dollar.

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Chairman Bernanke makes some interesting comments in his December 2012 Press Conference (p32) regarding US Treasuries. "So we're buying considerably less than the Treasury is issuing and, moreover, the share of outstanding Treasuries that the Federal Reserve owns is not all that different from what it was before the crisis, because while our holdings have increased, so has the-- obviously the stock of Treasuries in public hands. So it's not quite evident that there has been such a radical shift there. You know, we've been increasing our balance sheet now for some time, and we've been very clear that this is a temporary measure."

To what extent is the Fed Chairman accurate? Is the Fed Chairman trying to minimize the role of the Fed in financing (money printing for) the deficit and to understate potential overall exit strategy issues?

In reality, it doesn't look like the Fed's buying (at least nowadays) is "considerably less" than the Treasury is issuing. The current Fed policy involves gobbling up longer-term Treasury securities at a pace of $45 billion per month; if this continues for a year, that $540 billion represents a huge chunk of the Congressional Budget Office's baseline deficit estimate of $845 billion in fiscal 2013 (fiscal 2012 was $1,089bb; "The Budget and Economic Outlooks: Fiscal Years 2013 to

2023, Summary Table 1; February 2013). Won't the US have to pay higher rates to sell its debt if the Fed ceases buying such huge sums? Plus Bernanke's talk of "buying" only directly refers to the present time; he thus escapes discussion of its massive prior acquisition of UST.

As for his orations about the share of Treasuries in Fed's hands relative to the public, that still does not mean its holdings are puny. Besides, one should not forget about other holdings such as mortgage-backed securities. Scan a chart titled "Fed balance sheet relative to GDP" in the St. Louis Fed President's speech (2/14/13, p32). Make a rough estimate from the lines on this chart. From around six percent of nominal GDP in July 2008, the Federal Reserve Board balance sheet soared to around 15 percent through 2009 and 2010, rising further to around 18pc for 2011 up to mid-summer 2012.

Incidentally, the graph shows boosts by the European Central Bank, Bank of England, and Bank of Japan over this period, with their 2012 percentages exceeding that of the Fed. What are the exit strategies of these courageous central banks (and other central banks)? What if various central banks decide to abandon their current stance and implement their exit plans around the same time?

Bernanke bugles: "We've been equally clear that we will normalize the balance sheet, that we will reduce the size of our holdings, and—whether by letting them run off or by selling assets in the future. So this is, again, only a temporary step. It would be quite a different matter if we were buying these assets and holding them indefinitely. That would be monetization. We're not doing that."

However, despite the Chairman's statement, holding on to a substantial hoard of UST for a rather long time after engaging in massive money printing to pay for them arguably in practice closely resembles monetization. See Table 2 of the H.4.1 and its $1.73 trillion in UST. Of these, $400bb have a remaining maturity of one to five years, with $882bb over five up to 10 years, and $446bb over 10 years. Almost all the one trillion in mortgage-backed securities are over 10 years. So (and especially given the current Fed consumption of UST and its declared exit strategy regarding the sequencing and timing of its liquidation of its debt holdings), there will not be a significant run off of UST anytime in the near future.

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As a footnote on the rate front, Treasury interest rates can scramble higher not only to economic recovery (or by means of Fed money printing or other first aid remedies), but also because of substantial credit troubles. Recall some history, and not just of emerging marketplaces. The yield spikes of many European sovereigns such as Greece, Portugal, Italy, and Spain were not in ancient times. Suppose the US current and long-run federal fiscal debt (or the overall national indebtedness, including households) remains very high or rises further.

And even if the Fed keeps its foot on US government rates, deteriorating credit quality and higher interest rates in parts of the corporate sector eventually may appear (as in junk bonds).

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