novacapital | partners

> insight > focus > capital

Global Markets Commentary
March 10, 2011

The U.S. Fed-Led Recovery

Overview

- ***U.S. recovery depends on Fed, alternative monetary policy.***
- ***Risk takes center stage, but already priced in*.**
- ***US$100+ oil bad for U.S. economy, neutral/bad for inflation.***
- ***Middle East & North Africa unrest create unforeseen risk for U.S.***
- ***Labor, equities, and mortgage markets on the rebound, although the housing market still weak***

The U.S. recovery is losing strength. Or is it? It depends on who you ask these days. According to 43 forecasters surveyed by the Federal Reserve Bank of Philadelphia, the outlook for growth in the U.S. economy looks more positive now than it did just three months ago. In his twice yearly testimony to Congress, Federal Reserve Chairman Ben Bernanke recently acknowledged the threat of surging oil and food prices, but argued consumers wouldn't bear the burden and inflation would likely remain tame in the long term (less than 2 percent for each of the next three years).

Policymakers disagreed and political infighting is ongoing over the Republican's proposed US$61 billion budget cut, which means the central bank will step into the void and complete its US$600 billion bond-buying stimulus. This means the near-term future of the U.S. economy rests in the hands of the Fed, which is bad. Or is it? That too depends on who you ask. This uncertainty creates incremental risk. Thus, at just the point when all seems well on the road to recovery, we should begin to think about and price additional, risk. Or do we? Convention would say yes. But we are dealing with an historical application of alternative policymaking by the Fed in the form of quantitative easing—monetary expansion through the purchase of long-term assets (mortgage backed securities and long-term government bonds) to the tune of over US$1.3 trillion with another US$600 billion on the way. This is innovation at the policymaking level; and this is good (not only because it means risk has already been priced in but also because we are starting to see the results of this innovation).

Innovation, after all, is what propelled the U.S. economic engine to greatness in the 20th Century. Innovation is also what got the U.S. into this mess—that is, excessive innovation in the credit markets. This is the darker side of America's insatiable appetite for innovation, which oftentimes leads to creative destruction. On the surface it appears minimal effort is needed to get from point A to point B but just underneath the surface a furious and unnoticed effort is underway. This is occurring at the Fed and it will help get the U.S. economy from point A to point B and then on to point C; that is, from recession to recovery to boom, respectively.

Bernanke Speaks as Risk Takes Center Stage

The U.S. Federal Reserve's balance sheet continued to expand last week as the central bank bought more government debt in an effort to spur economic growth. The Fed's asset holdings in the week ended March 2 climbed to US$2.549 trillion, from US$2.537 trillion a week earlier, it said in a weekly report released March 3. It was the fourth consecutive week at which assets were above US$2.5 trillion. The Fed's holdings of U.S. Treasury securities rose to US$1.236 trillion last Wednesday from US$1.213 trillion the previous week.

In his recent testimony before Congress, the Chairman acknowledged surging oil and food prices, but said that inflation would likely remain tame. "My sense is that the increases we've seen so far—while tough for many people—do not yet pose a significant risk to the overall recovery," Bernanke said.

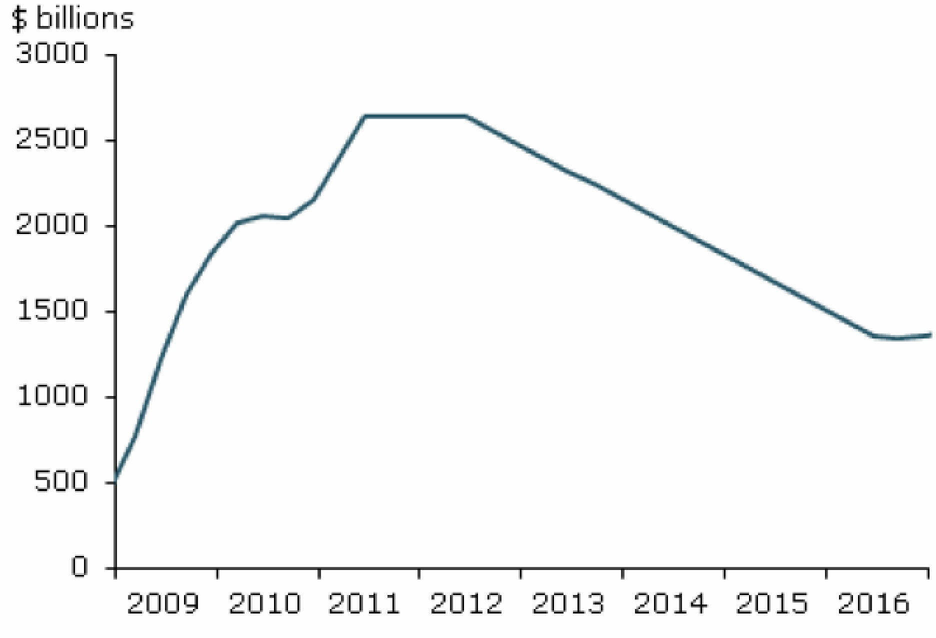
He spoke of the improving municipal bond market, jobs growth, QE2 unwinding, a commitment to keep inflation low, the unsustainable twin deficits, and the continued strength of the U.S. dollar in stark terms. He spoke of the negative impact the Republican-led US$60 billion budget cut would have on growth. One of the most important things he said related to the link between higher gas prices and inflation.

He stated that “the main risk from a price stability point of view would be if higher gas prices [started] feeding into the broader basket because people came to expect higher inflation and began to demand higher wage increases” and if that happened the Fed would take action to avoid an increase in inflation. “The relative price of oil, again, is primarily due to global supply and demand,” he added. (Meanwhile, as an aside, the IEA’s chief economist said high oil prices are a serious threat to global economic recovery and present a challenge the world will have to face over the long term!)

Bernanke then went on to defend the Fed’s second round of quantitative easing, which injects US$75 billion into the U.S. economy every month. The Fed’s large-scale asset purchases have been effective. By 2012, when asset holdings will peak before unwinding (see Fig. 1), the past and projected expansion of the Fed's securities holdings since late 2008 will lower the unemployment rate by 1½ percentage points relative to what it would have been absent the purchases (see Fig. 7). The asset purchases also have probably prevented the U.S. economy from falling into deflation.

With the Fed’s limited ability to reduce short-term interest rates, which provides stimulus to the economy and checks unwelcome disinflation (combined with a very high unemployment rate and measures of underlying inflation trending downward) participants in futures markets currently expect the federal funds rate to remain near zero until late 2011. Hence the Fed has adopted the alternative monetary policy approach of buying longer-term securities. The Fed purchased US$1.7 trillion in longer-term securities from late 2008 through March 2010 and in November 2010 announced its intention to expand the size of its securities holdings further by purchasing an additional US$600 billion in longer-term Treasury securities by the middle of 2011.

Figure 1. Projected path for Fed long-term securities holdings



Source: Federal Reserve Bank of San Francisco
Analysis and Calculations: Nova Capital Partners

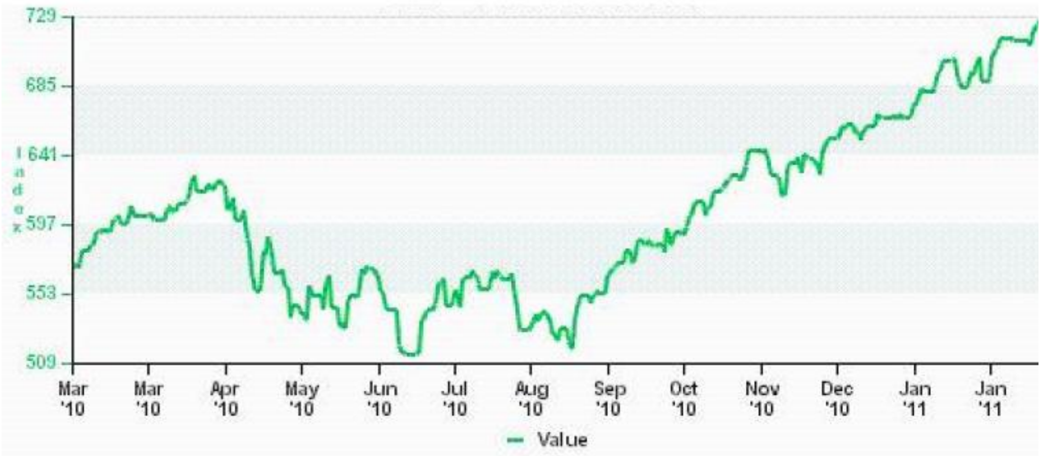
Recovery Watch Stocks

Expanding the balance sheet should have the effect of making mortgage funding more available and less expensive. This in turn will contribute to the U.S. economy strengthening, a development which we can probably help forecast by watching a small group of key stocks, rather than relying on a bond market which has yields which are still at extreme lows. Fannie Mae, which is still under U.S. conservatorship and trading on the OTC bulletin board, would be one such stock. Why FNMA? We believe the company will be profitable by YE 2011.

Elsewhere, given their dominance in the derivatives market, we should be watching J.P. Morgan Chase & Co., which recently vaulted to become the top energy dealer in the world's commodities markets, surpassing Goldman Sachs Group Inc. and Morgan Stanley (thanks to spending billions on acquisitions during the recession) and now holds 41 percent of the over-the-counter energy derivatives market. On the consumer side, Wal-Mart normally would tell us much about the state of the consumer with same-store sales in the U.S. dropping 2 percent in Q4:2010 (that's seven quarter-on-quarter declines). However, this continued drop in U.S. sales is attributed to losing customers on fill-in items—such as milk, bread, detergent, etc.—and overall results were boosted by continuing strong growth in its international business, especially in developing countries. Total revenues rose 2.5 per cent against the same period last year, to US$115.6bn, boosted by a US$665 million foreign exchange gain. Earnings rose 4.3 per cent to US$5.02bn, or US$1.70 per diluted share. Underlying earnings from continuing operations were US$1.34 per diluted share, 3 cents ahead of Wall Street's consensus forecast.

In the technology sector, the Morgan Stanley Technology Index (see Fig. 2) has a cross section of the best and brightest in the technology portion of capital expenditure spending.

Figure 2. Morgan Stanley Technology Index – 12 Months Index Value
(Data available from 01-Mar-2010)



Source: NYSE Amex
Analysis and Calculations: Nova Capital Partners

$150 Oil and the Capital Markets

Investors fear rising oil prices could derail the recovery of the equities market in the U.S.; but the increasingly strong correlation between equities and oil will provide a buffer (see Fig. 3). We have stopped short of suggesting where stock valuations, real interest rates and CPI may end up when the market perceives that higher oil prices are here to stay. Cutting oil production in half, Libya warned of US$130-a-barrel oil (some analysts say US$150!). This is unlikely because Libya was overproducing for the past five years (see Fig. 4); it probably will be closer to US$120 in the mid-term because market participants generally do not know how to price in “overproduction” vs. “underproduction” risk. This is still good news for U.S. oil bulls (not to mention oil exporting emerging nations, which will boost production and secure private investments), because even though the major oil companies remain bullish on the price of their product, the slow recovery prevents them from building out additional capacity to produce or refine. With OPEC’s leading exporter, the Saudis, putting their seal of approval on covering any Libyan oil production outage, the earnings outlook for energy stocks remains solid but US$150 oil is most unlikely in 2011 (barring a Middle East war).

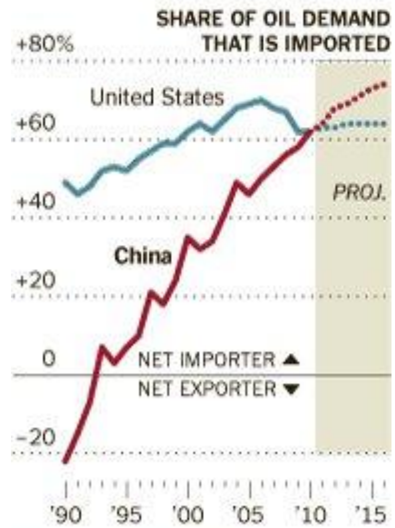
Add in earnings visibility and earnings models should begin to ratchet up the EPS forecasts for the oil patch. With only 13 percent of the S&P's market cap, the energy sector is likely to produce over 20 percent of the S&P's earnings this year. And with over 46 percent of February Exchange Traded Funds (ETF) inflows going into energy, jack-up rigs in short supply, and a growing backlog amongst infrastructure companies, the global search for income begins to focus on energy companies. There is nothing like backlogs, high dividend yields, free cash flow, and earnings visibility to put higher PE multiples on energy shares. Look for price expectations adjusting upwards in anticipation of higher earnings from the energy sector.

Though the Department of Energy (DOE) hasn’t said much about where the price of oil is going, the International Energy Agency (IEA) has, recently issuing a statement saying the proverbial “the age of cheap oil is over” and it expects prices to hike almost 30 percent. Considering that at this same time last year they were predicting US$86-a-barrel in 2015 (yes, that’s correct – a 5YR forecast!), the adjustment (a +52 percent “realignment”) is tremendously important, and has far-reaching effects. (How does that 2 percent inflation figure look, now, Chairman Bernanke?)

How does this affect the U.S. markets? According the Congressional Budget Office’s (CBO) website regarding the data sources it uses, “CBO uses the rich data sources available from the government's statistical agencies [as well as] information provided by relevant government agencies and industry groups to meet specific need.” Given the CBO uses IEA estimates in their analytical studies, does this mean that the oil component of all CBO analyses of legislative proposals and federal budget calculations will now increase 52 percent? If so, get ready for some weaker-than-expected economic numbers coming out over the next few quarters.

Oil Dependent

China, which once was a net exporter of oil, is concerned about its growing dependence on imported oil, which is projected to be higher than that of the United States this year.



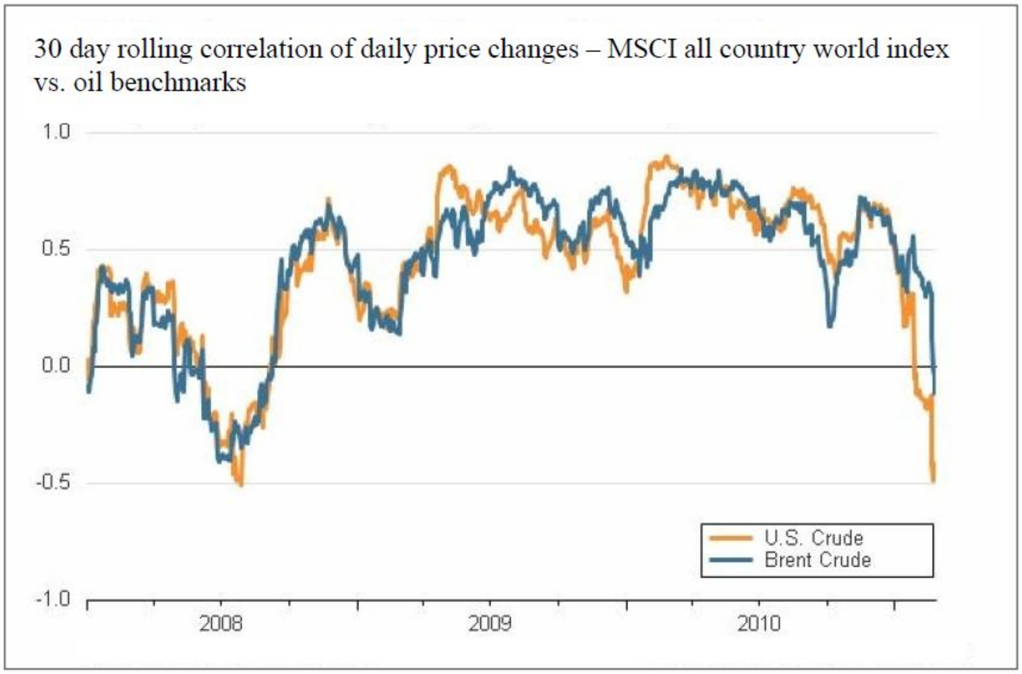
Source: Wood Mackenzie Energy Markets Service

OPEC’s recent announcement that its cutting of exports is due to maintenance and the decline of global consumption (as demand for winter fuel fades) prompted the United Arab Emirates, the third largest oil exporter, to reassure markets by declaring that it will continue to produce oil within its OPEC quota despite Libyan supply disruptions (which led Saudi Arabia to pump more oil), an official told *Reuters* last Wednesday. "The UAE is producing within its OPEC quota," an industry official told *Reuters*. Production is still in the range of 2.3 million barrels per day (bpd), while total capacity is around 2.8 million bpd, he said.

Although OPEC does have the production capacity to increase its quotas (many analysts say actual capacity exceeds OPEC’s publicly reported capacity), the ability to pump up the supply solves the problem as long as demand stays flat. That may seem unlikely given that last year for the first time, the Chinese surpassed the Americans in overall consumption of energy (from all sources and for all uses) and has also moved ahead of the United States as the biggest buyer of oil and natural gas from Saudi Arabia. The more the Chinese migrate from the countryside to the city and move from bicycles to motor vehicles, the more they need gasoline and diesel fuel. Today China, which as a net importer of oil views its energy needs as a matter of national security, consumes about one-tenth of the world's oil production, and according to the British Petroleum forecast it will double over the next 10 years and surpass America in 2030. According to an estimate by Wood Mackenzie, a global energy consulting firm, China imports nearly two-thirds of its oil and is on track to pass the United States in the percentage of imported oil this year. However, with oil prices at their highest level in more than two years because of unrest in North Africa and the Middle East, the Chinese government plans to announce strict five-year goals for energy conservation in the next two weeks, China energy specialists said on March 4.

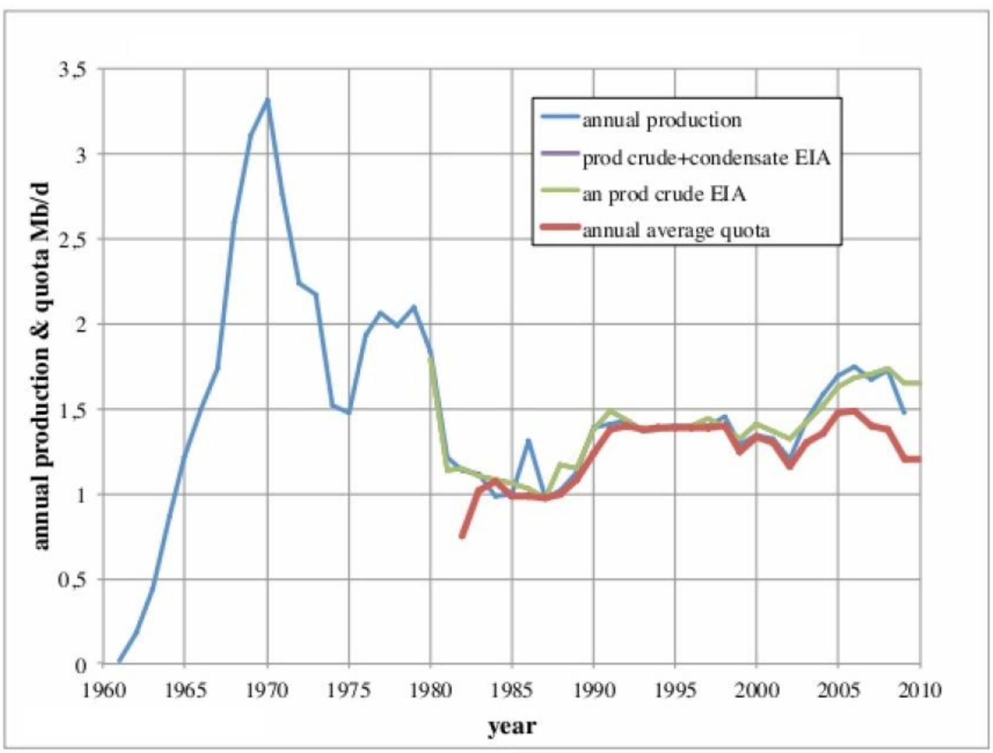
"Brazil, Canada, Azerbaijan, Colombia, and Kazakhstan are also forecast to be main contributors, while Mexico, U.K., and Norway are foreseen to experience the largest declines," OPEC said. In a monthly oil report released this month, OPEC has forecast world oil demand to grow by 1m bbl/day to 86.4m bbl/day in 2011. The report further said that the demand growth would be fuelled by non-OECD countries like China, India, Latin America and the Middle East. The recent push in the oil price above US$100 may seem as if "black gold" is hitting dizzying heights. But although the current turmoil plus fundamental economics of oil suggest the price can go higher (inflation-adjusted and within historical context) oil (though it may not be a bargain and it's still cheap) will have to stabilize long-term.

Figure 3. Oil price correlation with equities



Source: Thomson Reuters Datastream
Analysis and Calculations: Nova Capital Partners

Figure 4. Libya crude oil production & quota from OPEC with EIA data

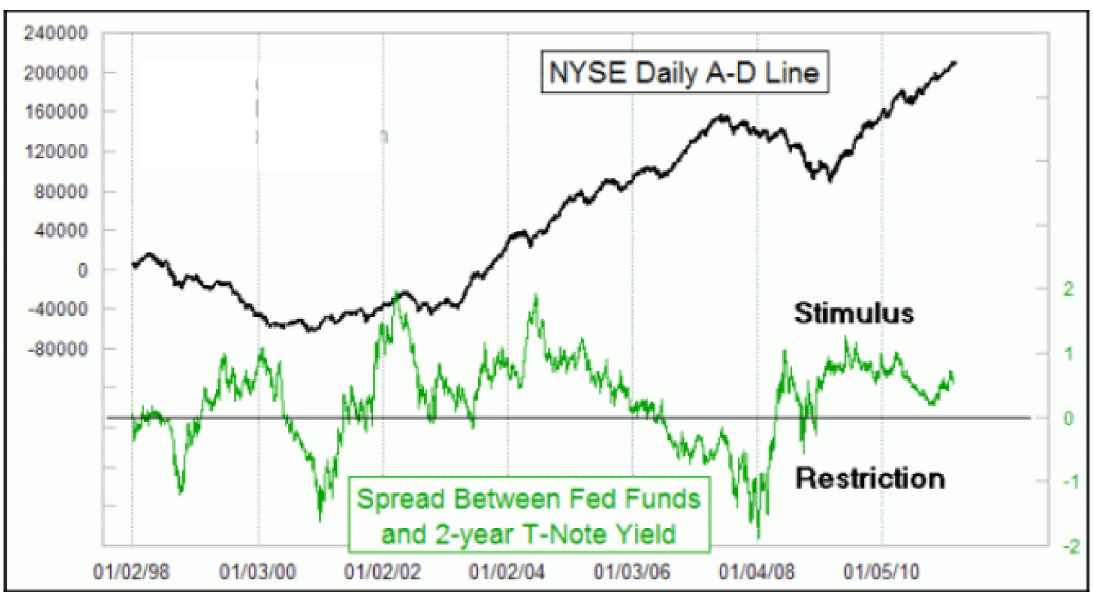


Source: Jean Laherrere
Analysis and Calculations: Nova Capital Partners

Volatility

The smartest bond managers we know are not managing bonds at the moment and, instead, are waiting for the Fed Funds/2 year note spread in the U.S. to close below 40 bps, which will unravel the carry trade bubble (a vehicle by which Bernanke allowed the banks to build up their capital base because they had depleted their capital so badly with the write-offs and the mortgage market that it was difficult for them to go into the market and sell new equity without tremendously diluting their current equity). We do not participate in the arbitrage business, but this thought rang a bell: If the hedge fund/fund of funds game these days is to earn steady ½ percent to 1 percent returns per month (with incremental returns expected to skyrocket as hedge funds raised bullish oil bets in February to record net long positions, a staggering 30 percent increase in just 7 days!), then the best way to do that is to execute oil arbitrage trades which appear to be virtually riskless—then leverage them up. But what happens when one of the big, "sure fire" oil arb deals suddenly goes bad, or the ability to finance those oil arb trades in a profitable way, suddenly goes away because the Fed Funds/ 2 year spread narrows? Financing has been a one-way trade. What happens if that changes? The VIX is trading around 18 a recent increase following the Mideast events - after falling 10 percent (the biggest decline since Nov. 18) and trending downward since its 9 month high of 45 last May, an unusually long string of low volatility readings. So it seems like people are willing to sell volatility. Certainly this could turn right back around as oil spikes higher and higher (which it will), but for now, the volatility market appears willing to accept US$100 oil—that is, as long as we keep getting good U.S. data. When risk is this far off the radar screen, is it really time to attempt to trade the next rally? Two things cause stock prices to fall: Higher interest rates and lower earnings. By year-end, we will have neither in the U.S. Will Bernanke's Fed looking to re-introduce the concept of risk into these markets via QE3? Will he begin to do so, by changing the Fed's language, putting up rates 50 bps at a time, or speeding up the timing of rate changes? No. Changing the face of risk via quantitative easing is the name of the game and will have effects on the markets through 2015.

Figure 5. Fed Funds-2 year T-Note spread



Source: Mclellan Financial
Analysis and calculations: Nova Capital Partners

U.S. Financial Stocks

As we predicted they would in earlier pages, U.S. companies showed strong profits in Q4:2010, as productivity gains drove margins higher. Out of the 287 S&P 500 companies that had reported results as of February 4, more than 70 percent outpaced estimates on revenues and earnings, according to data available from *Bloomberg*. Earnings on an aggregate basis rose 40 percent during the fourth quarter. Average revenues grew at a more modest pace of 8 percent but will cross double-digit territory in Q2 as the recovery picks up momentum. If we combine the U.S. banks stocks with the non-bank financials, they make up about 16 percent of the S&P 500 weighting. Both bank and non-bank financials have been declining for some time, i.e., their charts do not look good. But now financials were the clear top performers on the bottom line. Banks continued to see the benefits of improving credit quality across the board, with weaker regional banks also starting to see marked improvement in performance. This improvement translates into positive leading indicators included in USA TODAY/IHS Global Insight Economic Outlook “Recovery Watch” Index. If the U.S. economy is about to pick up steam, and we think it is, consumer stocks are a buy. And if the bank stocks are just beginning to outperform, we should own them. And the astute investor does. That leaves technology at about 18 percent of the index, in terms of putting a lot of money to work. But do we really want to add risk (technology stocks) to the equity portfolio given the Fed is experimenting with alternative monetary methods, the U.S. dollar is holding its weight (with the boost in exports [thanks to the lower dollar] behind us), and NASDAQ having jumped over 30 percent since September 2010? No (except for the MS Tech Index). Yes to financials and consumer stocks though. Utilities will struggle until the Fed’s quantitative easing strategy begins to unwind and interest rates peak (probably in 2015). There is a scenario where oil prices simply head straight for US$150, pushing the energy sector to a much higher S&P weighting; but again, this is highly unlikely. Some natural gas stocks are behind the oils and we should also be looking for alternative energy companies, which are trading at deep discounts because accurate information in this boom industry is still absent and the world will (need to) embrace clean energy as a viable means for both securing high, low risk adjusted incremental returns and resolving the coming oil crisis.

Consensus

The markets are priced for 2 percent inflation in the U.S. U.S. consumer prices rose a seasonally adjusted 0.4 percent in January, driven by higher food and energy expenses. The core consumer price index, which strips out volatile food and energy costs, rose a lesser 0.2 percent. Economists had forecast CPI to rise 0.3 percent overall, with a 0.1 percent increase in the core rate. Consumer prices are up 1.6 percent over the last 12 months. With the CPI report translating into almost a 5 percent annualized rate, the Fed is counting on the alternative monetary policy of asset purchases to keep inflation contained. Given the unforeseen hike in oil prices (new incremental risk that had not been priced in to the market) if not for the asset purchases, we contend the asset classes most at risk would have been the bond market and high beta equities. Several weeks ago we wrote that ten year Treasury yields will rise to 3.5 percent in the near-term. The long Treasury bond needs about 200-300 bps over the inflation rate in order to stabilize. With year-over year-core CPI coming in at 0.95 percent, that means the 10-year Treasury yield is headed for 4 percent, which is historically not a high rate, but it is less than 50 bps under the 200-day average for top quality U.S. bonds, which are about 4.5 percent or even a touch lower. U.S. company bond sales more than tripled last week as equities advanced and economic data showed a strengthening U.S. labor market. The speed of the coming move in bonds is the key factor. If bonds go to 6 percent this year, bond returns will be negative, while stock returns will be positive. But if the move to 6 percent or an overshoot to 7 percent takes 2 years, the economy will adjust thanks to the Fed's bet on alternative asset purchases and the disruption to equities will be minimal. However, not all equity sectors will be equal. U.S. bank stocks, for example, are undervalued. Neither will all equity markets be equal. But companies generally will produce resilient results this year. Low PE, high dividend income, financially strong companies will come back into investment favor. Free cash flow with high dividend yield companies will increase in emerging market nations. Liquidity from the rich world will end up in developing nations (via the commodities market) and will drive stock prices in those developing nations (rather than just profits). The opportunity is to find inefficiently priced assets in firms that are benefiting from developing nation's growth. These companies will offer more stable earnings as poor countries continue to mature and stabilize. As stated earlier, equities of renewable energy companies with low PE multiples will be the best bet because market data is currently incomplete in this new economic boom sector. All-in-all, very few firms seem willing to entertain the idea that 2011 could turn out to be a negative year for equities.

Inflation, the U.S. Long Bond, and Employment

The major wildcards for bonds remains the foreign investor (will they continue to fund the U.S. deficits at the current interest rate?), the potential for deleveraging (closing out of the U.S. carry trade), an expansion in credit spreads, proper measurement of inflation, China/Asia's long term reduction of Dollar/T-bond buying, and a secular downshift in consumer spending with a corresponding rise in the savings rate. We know from the Treasury data that the Chinese have cut back dramatically on their purchases of both USD assets and U.S. Treasuries and other U.S. government bonds. In 2010, for the first time ever, China invested more overseas in assets—iron ore in Sierra Leone, mines in South Africa, coal and gas in Australia, oil in Brazil and Venezuela, even timber from Canada—than it put into U.S. government bonds, spending US$31 billion on hard assets compared with US$23 billion on Treasuries and other U.S. government bonds. For many years, the mainland spent next to nothing on hard assets abroad, while its purchases of U.S. government debt ranged as high as US$100 billion a year. The good news is U.S. alternative monetary policy will pick up the shortfall.

Hedge fund assets rose 5.7 percent in Q4:2010 to almost US$2.5 trillion, as emerging markets equity managers saw pretax profit jump substantially (many over 50%). In the past, government sponsored entities (GSEs), the UK and large speculators had been funding the U.S. government. But the GSE's tend to buy bonds during an "up" refi cycle, and that cycle has been turning down for quite some time. The Fed's "new recovery era" is seeing alternative balance sheet expansion, which means increased demand for bonds. Meanwhile, foreigners must be demanding higher interest rates to compensate for losses on U.S. dollar positions and/or a solution to the twin deficits plus a stronger U.S. dollar. So, in the past where the Fed eventually had to print U.S. dollars in order to fund the U.S. budget deficit today's alternative quantitative easing is the alternative (or complement). The primary objective of the Fed's large-scale asset purchases is to put additional downward pressure on longer-term yields at a time when short-term interest rates have already fallen substantially. Such a reduction in longer-term yields is leading to stronger financial conditions overall, thereby helping to stimulate real economic activity and check undesirable disinflationary pressures. In many ways, it supports conventional monetary policy, which primarily influences long-term yields through changes to the current and expected future path of the federal funds rate.

How do the Fed's asset purchases affect long-term interest rates? Three main channels have been identified. One is that the market sees that the Fed intends on holding short-term interest rates low for a longer time. This expectation of lower future short-term interest rates lowers long-term rates. A second channel is through beneficial market effects that such purchases can have in times of stress. For example, the spreads between mortgage rates and U.S. Treasury yields rose to very high levels during the height of the financial crisis in late 2008, but fell markedly after the Fed announced its intention of buying agency mortgage-backed securities (MBS) guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. The third channel–and probably the most important–results from the way central bank asset purchases reduce the overall supply of longer-term securities available to investors, thereby pushing up securities prices and pushing down yields. As a result, the Fed should be able to lower longer-term interest rates if it can substantially reduce the stock of longer-term debt held by the private sector.

To accomplish this reduction in longer-term interest rates, the Fed in 2009 and early 2010 purchased about US$1.25 trillion in agency MBS, US$170 billion in agency debt issued by housing-related government-sponsored enterprises, and US$300 billion in longer-term Treasury securities. This was followed by the US$600 billion program to buy additional longer-term Treasury securities, announced after the November 2010 meeting of the Federal Open Market Committee (FOMC). The FOMC also said it would continue to reinvest principal payments on its holdings of these longer-term assets, a policy announced in August 2010. Collectively, these actions, partially offset by earlier redemptions and MBS principal payments, are expected to boost securities holdings in the Federal Reserve's System Open Market Account (SOMA) to US$2.6 trillion by the middle of 2011, consisting essentially of assets with an original maturity of greater than one year. In mid-2007, prior to the crisis, Fed securities holdings were only US$790 billion. These purchases have been accompanied by significant increases in bank reserve balances at the Federal Reserve.

How long can the U.S. continue to fund a federal deficit which is expected to top a historic level by adding US$1.7 trillion in 2011, from so many external sources? Is the foreigner putting much of their new capital in money market instruments rather than long dated U.S. debt? The single biggest component in the U.S. budget is interest costs (most U.S. Treasury debt lies at the short end of the yield curve), and short rates have started up. While this may attract additional foreign buyers, it will also increase the budget deficit. In the near term, neither short nor long-term interest rates can be allowed to rise too fast, given the critical role the U.S. consumer is playing in the world economy and the amount of leverage which exists in the U.S. economy. But they can rise many analysts fear that a 6 percent long Treasury bond is a possibility. Shutting down the U.S. consumer via rising interest rates is a prescription for a protracted recovery, while China’s manufacturing sector is already under stress. We are looking for a slow yield curve to develop at some time during the next four quarters as asset purchases take hold. Normally long dated Treasuries carry a 200-300bp positive real yield; without the asset purchases a 10-year would have a negative real yield of approximately 100 – 200 bps. The other major risk without asset purchases would be the bond market pricing in upward revisions in the CPI.

As we projected in our January piece, employment gains beat expectations with the unemployment rate declining to 8.9 percent, the lowest level since April 2009. U.S. private employers added 217,000 jobs in February, already beating analysts' expectations, a report by payrolls processor ADP Employer services LLC showed. Economists polled by *Reuters* had expected a rise of 175,000. The January figure was revised higher to 189,000 from 187,000.

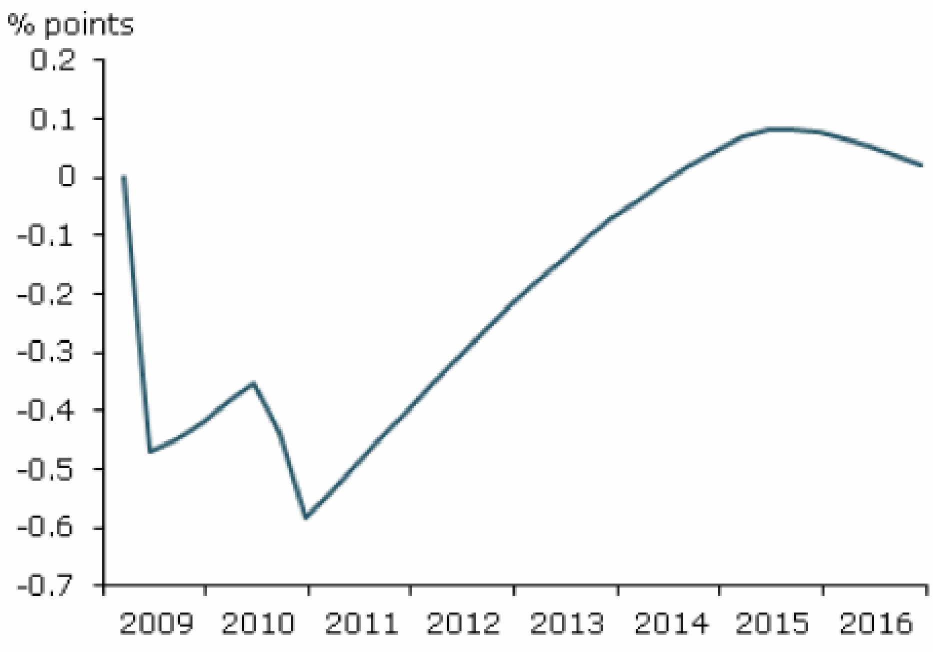
What do These Charts Mean?

We have three interesting charts here which must be thought of in terms of what they mean for the capital markets. The first (see Fig. 6) summarizes the predictions of portfolio-balance effects from the Fed's large-scale asset purchases. In this figure, and those following, the lines plot the effects of the asset purchase program. When the first phase of the program initially was announced, the 10-year Treasury yield dropped by about half a percentage point (50 bps).

During the next few quarters, yields began to move go back up until pushed lower by the introduction of the next two phases of the program. The program's effect on longer-term Treasury yields fades quickly after late 2010 primarily because portfolio “renormalization” inched nearer. The notches in the curve reflect the introduction of changes in the asset purchase program, which we assume were unanticipated by market participants beforehand.

What this shows is that lower long-term interest rates produce higher stock market valuations and a modestly lower foreign exchange value of the U.S. dollar. These changes in financial conditions provide considerable stimulus to real economic activity over time. The full program raises the level of real GDP almost 3 percent by the second half of 2012. In turn, this boost to real output makes labor market conditions substantially better than they would have been without large-scale asset purchases, benefits that are predicted to grow further over time. By 2012, the full program's incremental contribution is estimated to be 3 million jobs, with an additional 700,000 jobs generated just by the most recent phase of the program.

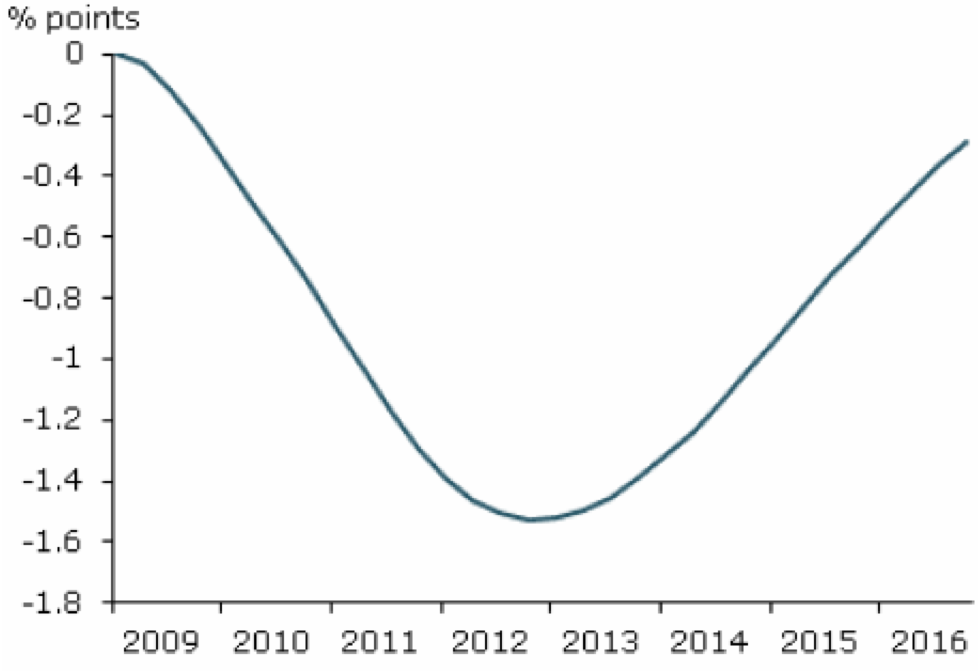
Figure 6. Effect of Fed’s asset purchases on 10-year Treasury yield



Source: Federal Reserve Bank of San Francisco
Analysis and Calculations: Nova Capital Partners

Increased hiring lowers the unemployment rate by 1½ percentage points compared with what it would have been without the Fed's asset purchases (as shown in Fig. 7). What many analysts don't realize is that providing the same amount of support to real economic activity through conventional monetary policy would have required cutting the federal funds rate approximately 3 percentage points from early 2009 through 2012, an obvious impossibility because of existing low rates.

Figure 7. Effect of Fed's asset purchases on unemployment rate



Source: Federal Reserve Bank of San Francisco
Analysis and Calculations: Nova Capital Partners

Finally, the asset purchase program has contributed importantly to price stability. Figure 8 implies that inflation is currently a percentage point higher than it would have been if the FOMC had never initiated the program, meaning that the economy would now be close to deflation.

The figures also suggests that the longer-run inflationary consequences of the program are likely to be minimal, as the asset purchase effects rapidly fall to zero and conventional monetary policy adjusts to bring conditions back to "normal." In part, this long-run neutrality reflects we have confidence in the FOMC's determination and ability to maintain price stability–a belief that policymakers ratify.

Overall, these results suggest that the Fed's large-scale asset purchase program is providing significant support to real economic activity and the labor market. The program may also be offsetting deflationary pressures, (as long as we continue to anticipate the Fed will not tighten vis-à-vis the application of conventional monetary policy over the medium term).

Figure 8. Effects of Fed's asset purchases on core inflation (four-quarter change)

Source: Federal Reserve Bank of San Francisco
Analysis and Calculations: Nova Capital Partners

Some Facts About the Fed's Mortgage Market Investments

The only good news for the housing market is, the effects on the primary U.S. mortgage market that the large scale asset purchase (LSAP) program in which the Fed bought US$1.25 trillion of mortgage-backed securities in 2009 and 2010 are starting to take shape in two forms: stimulating consumption and stabilizing house prices. On November 25, 2008, the Federal Open Market Committee (FOMC) announced a plan for the Federal Reserve Bank of New York to purchase US$500 billion dollars of mortgage-backed securities (MBS) issued by the two main GSEs for housing, Fannie Mae and Freddie Mac, as well as ones guaranteed by the government agency Ginnie Mae. The purpose of the so-called large-scale asset purchase (LSAP) program was to reduce the spread between mortgage interest rates and other interest rates of similar duration. In its initial press release, the FOMC said: "Spreads of rates on GSE debt and on GSE-guaranteed mortgages have widened appreciably of late. This action is being taken to reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally."

The FOMC expanded the LSAP program in March 2009, and overall the Federal Reserve purchased US$1.25 trillion of agency MBS between January 5, 2009 and March 31, 2010, the program's official end date. In addition to the MBS purchases, the Fed also purchased US$175 billion of GSE debt and US$300 billion of Treasury securities. This corresponds to about 22 percent of the total outstanding stock of these securities at the beginning of the LSAP program, indicating the substantial size of the intervention.

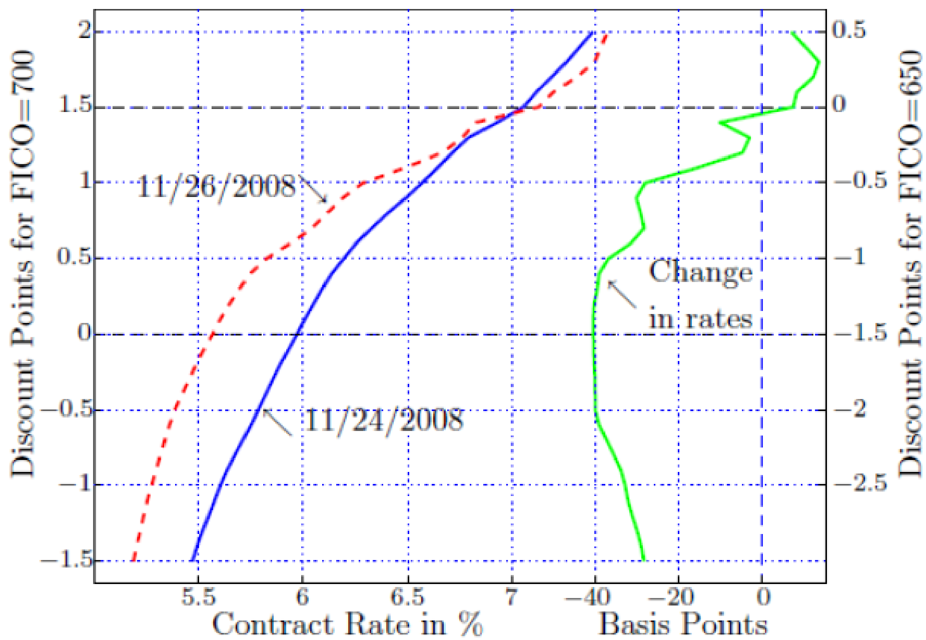
How has this affected the mortgage market?

First, the announcement of the LSAP program almost immediately led to significant reductions in interest rates for borrowers. Measuring how much rates decreased is far more difficult than it might sound because there was wide variation in the size of the reduction across borrowers and loans.

A borrower's credit score, loan-to-value ratio, other characteristics of the loan or the property, as well as whether the borrower wanted to pay discount points or receive money from the lender to cover closing costs—all these factors matter for the extent of the interest rate change.

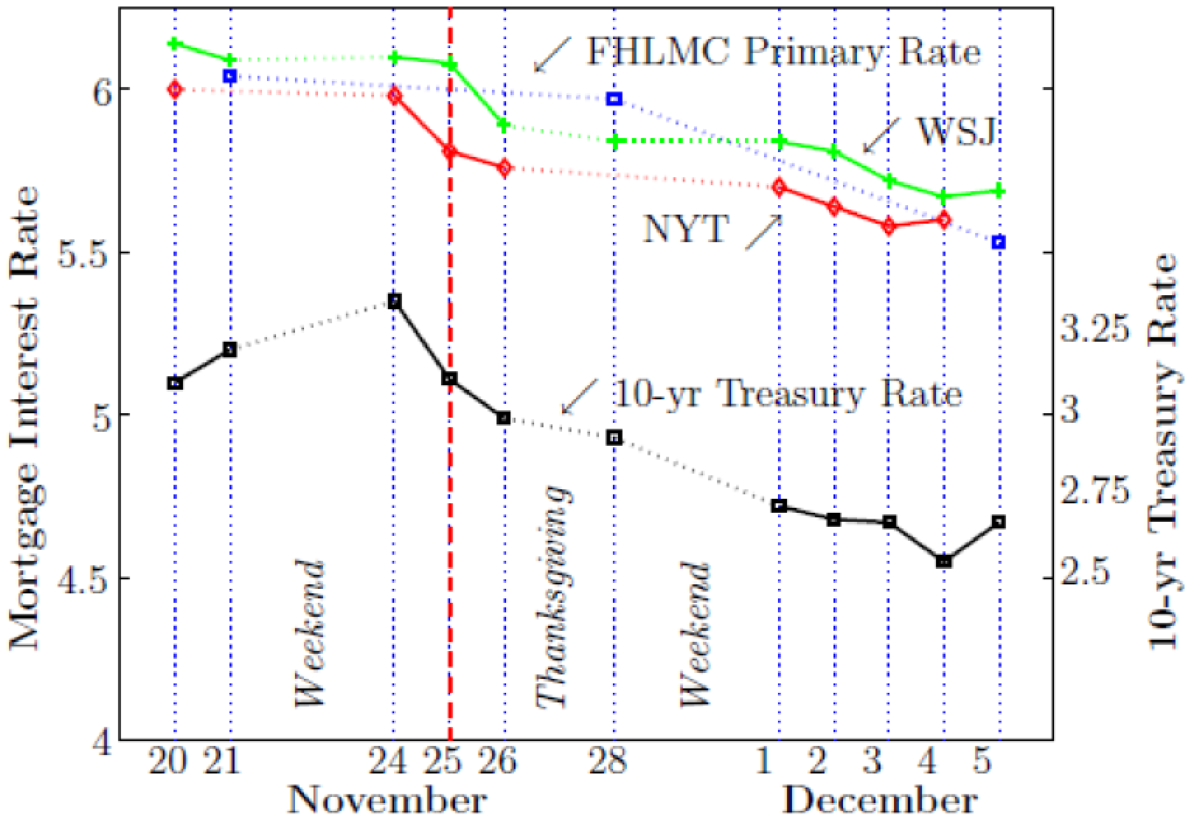
However, we know thanks to the Federal Reserve Bank of Boston that the changes in rates accompanying the LSAP announcement saw a reduction of 41 bps, a boon for many borrowers (see Figures 9 & 10)!

Figure 9. The effect on borrower options of Nov. 25, 2008 LSAP program announcement



Source: Federal Reserve Bank of Boston
Analysis and Calculations: Nova Capital Partners
Note: The rates on respective days (left part of the figure) and the rate change between the 2 days (right part of the figure) for a different numbers of points can be read using the left axis for a 700 FICO borrower or using the right axis for a 650 FICO borrower. For instance, reading from the left, a 700 FICO borrower receiving 1 discount point got a rate of 6.57 on 11/24 and 6.29 on 11/26 for a reduction of 28 bps. Reading from the right, a 650 FICO borrower paying a 1 discount point got a rate of 6.20 on 11/24 and 5.83 on 11/26 for a reduction of 37 bps.

Figure 10. Interest rates over the period immediately before and after the initial announcement of the LSAP program on 11/25/08



Source: Haver Analytics
Analysis and Calculations: Nova Capital Partners

Second, the Fed's initial announcement led to an immediate and large increase in borrower activity in the primary loan market. Data show an increase of approximately 300 percent in the number of borrowers shopping for refinance mortgages on November 25 compared to preceding days, which translated into a 150-250 percent increase in the number of applications and subsequent originations.

These increases in activity persisted and peaked in mid-December and early January, and then again after the extension of the LSAP program was announced on March 18, 2009.

The Home Mortgage Disclosure Act (HMDA) data also show that the percentage of applications turning into originated mortgages discontinuously increased after the LSAP announcement, meaning that looking only at an index of applications would lead one to underestimate the program's true effects on the U.S. mortgage market. The HMDA data further reveal that the time between application and origination increased significantly in the months after the announcement, which means lenders were having trouble processing the increased volume of applications.

What does all this mean? It means the Fed's alternative monetary policy is working.

Conclusion and Outlook

Milton Friedman once famously quipped that, "I have, for many years, been in favor of replacing the Fed with a computer." Speaking in a 1999 interview, Friedman went on to add, "The Fed has had very few periods of relatively good performance. For most of its history, it's been a loose cannon on the deck, and not a source of stability." This may have been true for many years but perfecting economic models takes time and much improvement, after hard lessons learned, has been made since economic forecasting gained widespread support in Washington in the 1960s.

So what then are we to make of the economic figures coming out of the U.S.? Employment has risen and the trend will continue (as we anticipated late last year), Q1 earnings will show marked improvement, the Middle East and North Africa crisis will stabilize in the long run (but the price of oil won't in the short run), and late in 2011 we think the U.S. economy is likely to begin to expand quickly—regardless of the upcoming global oil crisis. Traditionally benefiting from investment flows during times of geopolitical instability, the U.S. dollar's 8 month decline, which has been a big advantage for U.S. exporters, will also stabilize. Still, U.S. multinationals will not mind if the USD declines further; however emerging market nations may.

For the past 15 years, the world economy depended, almost required, a strong U.S. dollar and a strong U.S. economy. With much of the world's central bank reserves still in U.S. dollars, and the value of the USD falling, how can global central bank balance sheets expand, creating lasting economic growth if the U.S. dollar does not rally? With the global recovery underway, the emerging markets game-changing renaissance here to stay, surging current U.S. account/budget deficits, and a resurging struggle for democracy taking place across the globe (with "black gold" getting caught in the middle), and a potentially comparative destructive global clean energy race heating up, the relationship between America's much needed economic weight and the rest of the world remains balanced on a narrow economic ridge.

With that said, these global imbalances are unsustainable and will create future problems for the world economy if not tackled now. The cost of the Iraq and Afghanistan wars (and possibly the upcoming Mideast wars), along with the ongoing cost of reconstruction and peace in Iraq continues to put severe long-term pressure on the U.S. budget deficit. In the short-term, the U.S. dollar therefore has to maintain strength. Long term, however, with emerging market nations gaining the upper comparative advantage, the U.S. dollar will have to weaken much further, perhaps by as much as another 15 percent. Gold will pass US$2000 per ounce and will continue rising toward our long-term target of US$3500. Thus innovation at the policymaking level will (have to) continue and show real results; and, as a result, alternative monetary policy will gain the respect of Wall and Main Streets.

Written by Luke A. Eckblad
Head of Research
(212) 321-7093
www.novacapitalpartners.com