Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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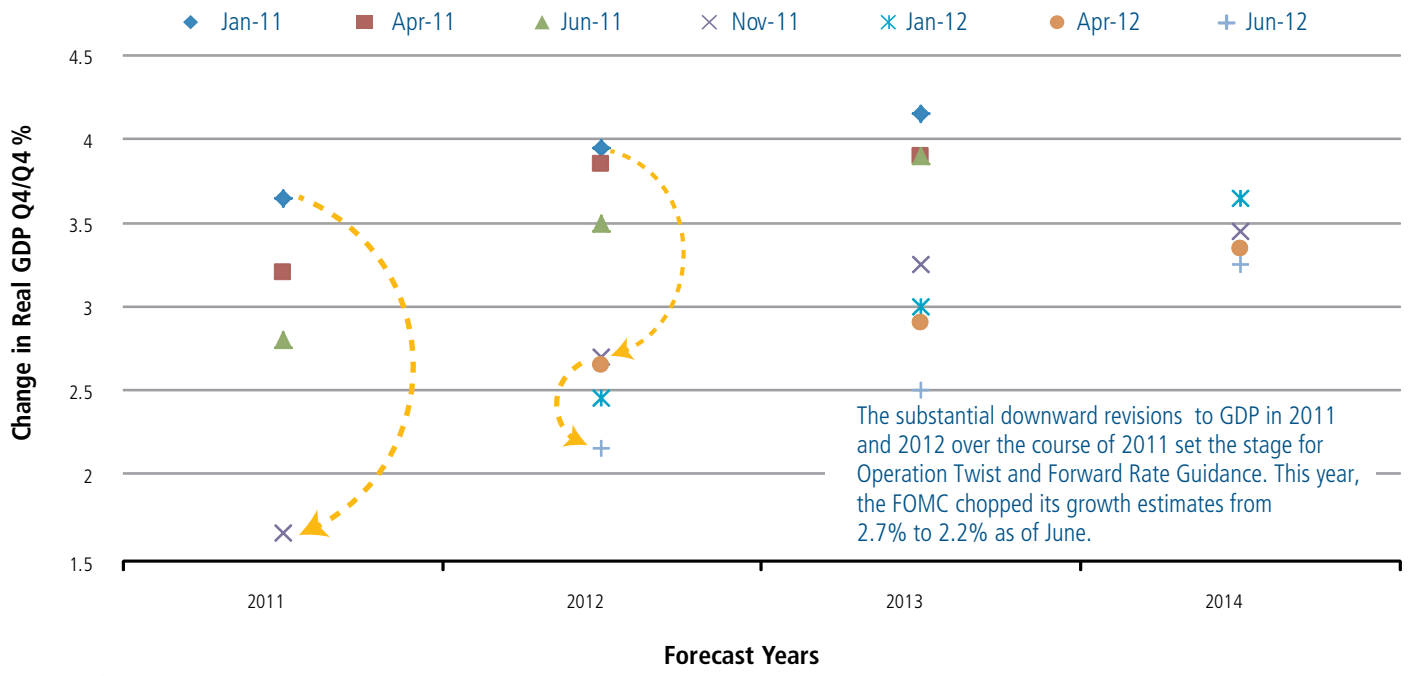
From The Economics Team: Still "Wait-and-See" Mode, More Monetary Medicine Won't Heal Economy

After days of ink spilled and pixels wasted, speculation about "QE3" reached a feverish pitch this morning with the Federal Open Market Committee's (FOMC) statement. The Fed's failure to deliver on additional outright purchases of securities dashed hopes for "QE3." Instead, the FOMC announced a six-month extension of its Maturity Extension Program (MEP, dubbed "Operation Twist" by the market), which entails selling short-term Treasuries to buy longer-term Treasuries. Rather than expanding its total bond portfolio, the Fed chose to keep the size of its portfolio constant (at $2.8 trillion) and adjust the composition of holdings.

Will the Fed do more? We think Fed policy shifts occur when actual economic data runs counter to Fed forecasts (See Chart 1). We witnessed this in October 2010 with QE2 (the FOMC missed on inflation forecasts) and in September 2011 with MEP (the FOMC missed on growth forecasts). In the economic projections released after today's meeting, the FOMC downgraded its economic growth forecasts by -0.5% for 2012 and -0.4% for 2013 compared to April–substantial downward revisions. This lowers the bar for additional easing at the meetings ahead if slow growth and sluggish job gains persist but does not guarantee it. Wait-and-see mode remains the order of the day. Keep in mind, additional easing would not necessarily be confined to QE3. It could include changes to the "forward rate guidance" in the policy statement (as hinted at by Fed Vice Chair Janet Yellen recently).

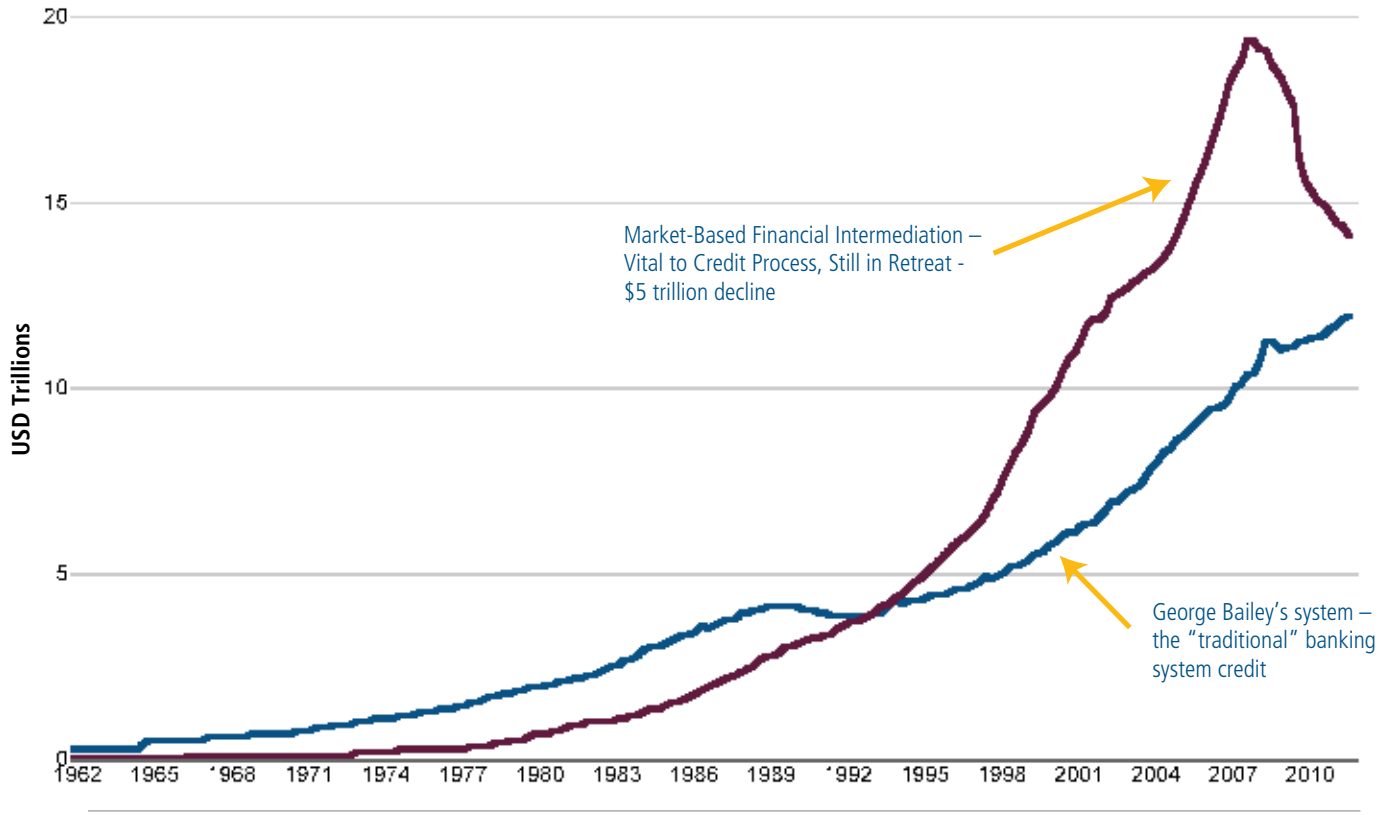
Our View on QE Where our view is unique is on the ineffectiveness of "QE" in any form, Operation Twist or QE3. There are two key reasons for this. First, QE replaces one set of high-quality liquid assets (Treasuries) with another high quality liquid asset (central bank money). Or in the case of MEP/Operation Twist, the Fed replaces one high-quality liquid asset (shorter-term Treasuries) with another set of high-quality liquid assets (longer term Treasuries). This impacts the capital markets by removing private sector duration but the broad supply of money and credit is unaffected–in fact, total money and credit continued to contract through the first quarter of 2012 (See Chart 2 attached). This translates into weaker economic activity.

Chart 1 — FOMC Growth Downgrades Presage "Operation Twist" and "Forward Rate Guidance" Shifts…What's Next?



Source: Federal Reserve

Chart 2 — Yes, Interest Rates Are Low But Where Is The Money (and Credit)?



Source: Federal Reserve, *=Shadow Banks are financial intermediaries without access to central bank liquidity or public sector guarantees (Pozar, Adrian, Ashcraft, Boesky, 2010)

Second, many structural factors impede a faster US recovery. The Fed's swapping one set of liquid assets for another set of liquid assets does little to aid this restructuring (e.g., turning a construction worker into a nurse), particularly since policy makers have done little to promote the recovery of money and credit. More monetary medicine from Dr. Bernanke will not change this reality. To his credit, Chairman Bernanke displayed uncertainty about the impact of more QE during the Q&A session of today's press conference, reiterating that "monetary policy is not a panacea" and that many factors cloud the economic outlook (e.g., weather, euro area crisis, etc.).