Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

OCTOBER 24, 2012

October FOMC - No News, Action Abounds

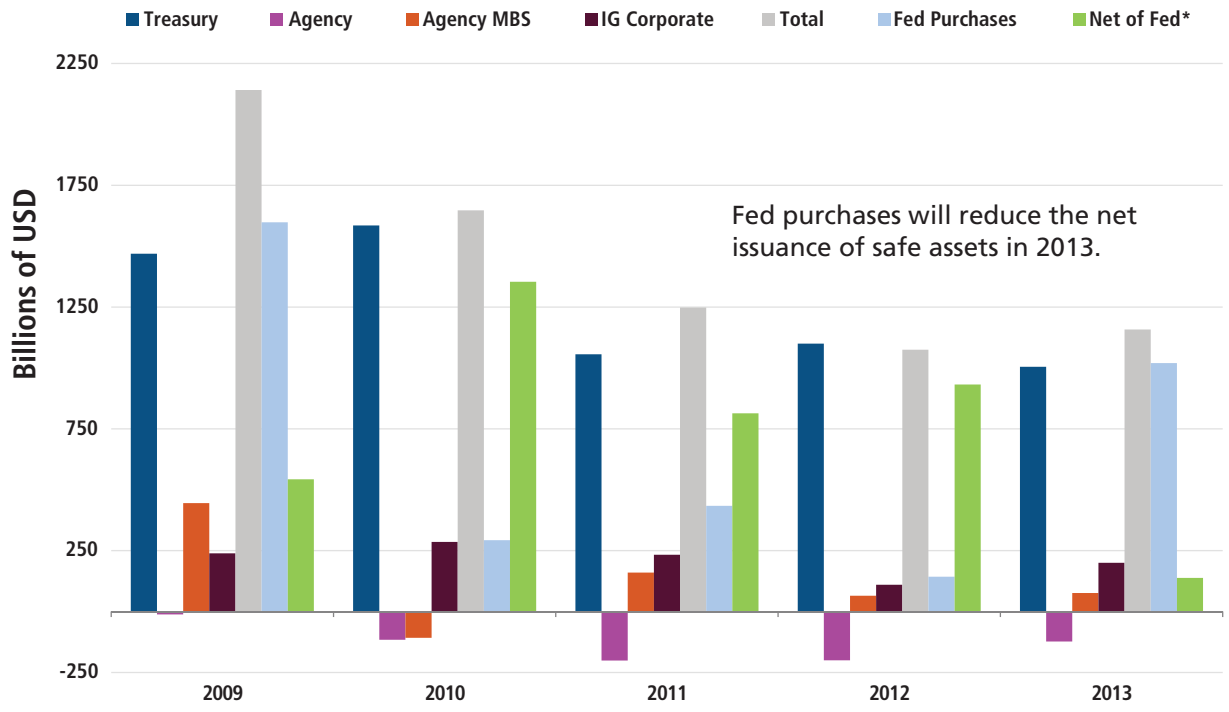
Produced during what was the second to last Federal Open Market Committee (FOMC) meeting of 2012, today's FOMC statement brought little unexpected news. After the previous meeting's unprecedented "QE3" announcement, the market was prepared for an uneventful session. The FOMC's statement reaffirmed their commitment to conditional purchases of USD40 billion worth of agency mortgage-backed securities (MBS) per month aimed at keeping rates low until mid-2015. But challenges lie ahead for policymakers—and, more importantly, for investors.

Though the broad message remained the same, the FOMC made slight changes to the language of the statement. Policymakers judged **that household spending had "advanced a bit more quickly"** even as **business fixed investment "h[ad] slowed."** More significantly, Richmond Fed president (an inflation hawk) Jeffrey Lacker reiterated his distaste for "additional asset purchases" and "disagreed with the description of the time period over which a highly accommodative stance of monetary policy will remain appropriate."

While we knew that Lacker was no "QE3 devotee", his explicit disagreement with the description of the time period contains clues about the FOMC's recent discussions. As we learned from the minutes of the September meeting, much of the debate surrounding QE was whether or not the FOMC would use "numerical thresholds…to provide more clarity about the conditionality of forward guidance." While they have, for now, used a calendar date to indicate the first expected rate hike (mid 2015), some expect explicit economic targets that would determine tightening could be the next step.

What's ahead? The FOMC meets again in December. In the interim, the Labor Department will release two employment reports (for October and November), giving the FOMC fresh evidence about labor market conditions. Since the Fed has pledged to "continue its purchases of agency mortgage-backed securities, undertake additional asset purchases [e.g., Treasuries after Operation Twist ends in December] and employ its other policy tools as appropriate until" the Committee sees "the outlook for the labor market improve substantially," the Fed's balance sheet could balloon. Growth in the Fed's balance

NET SUPPLY OF "SAFE" ASSETS BEFORE AND AFTER FED PURCHASES



Source: RBS

*Assuming in January 2013 the Fed continues to purchase USD45 billion in Treasuries per month, and continues to purchase USD40 billion in Agency MBS.

sheet of just $40 billion per month (for example) until the unemployment rate reaches 6% could bring the Fed's balance sheet from the current $3 trillion to $4 trillion and beyond.

This ongoing central bank balance sheet expansion poses challenges for the bond market and bond investors. We do not foresee an immediate, direct inflationary impact from the Fed's balance sheet growth **(see our latest *Point of View* for more on the link between central bank balance sheets and inflation)** and we remain skeptical on QE as *the* spark for new hiring activity (91% of CEOs surveyed by Duke University last quarter reported that even a one percentage point drop in interest rates would not alter hiring plans).

However, by removing safe and liquid assets from public circulation, QE3 has and will continue to have significant effects in bond markets. QE will push bond yields lower than otherwise, forcing bond investors to seek investment opportunities elsewhere. In fact, if the FOMC continues to purchase agency MBS and Treasuries throughout 2013, ***the Fed risks removing almost all of the net issuance of high quality fixed income assets from the market supply for the year*** (see Chart on previous page).

Investors should not confuse the lack of news out of the FOMC meeting with an absence of market impact.