Commentary

The FOMC and the Dangling Carrot

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Markets continue to shrug off the recurring headwinds from across the Atlantic, despite the evolving threats posed by the European debt crisis. The latest chapter in this saga was the multi-country downgrade on Friday January 13. Late that afternoon, Standard & Poor’s (S&P) downgraded the credit ratings of nine countries, including France which, along with other notable countries such as Austria, lost its AAA status, just as the U.S. did in August 2011. The muted reaction in financial markets has several possible explanations. For one, the downgrades were expected; S&P’s report in early December made clear there was a high likelihood of mass European government downgrades. Another reason—one that carries at least as much weight in our view—is the historically activist stance of central banks.

**Central Bank Support**

Markets remain supported by both central banks, which have embarked on various forms of monetary stimulus, and improved expectations regarding U.S. economic growth. Most recently, the European Central Bank (ECB) lowered its overnight lending rate by 25 basis points at both its November and December meetings, reversing its two prior rate hikes of 2011. The Bank of England (BOE) embarked on an asset purchase plan in the fourth quarter of 2011, which is scheduled to end in February. Current consensus is that the BOE will launch a similar plan following completion of the current one. In late 2011, the U.S. Federal Reserve’s (Fed) Open Market Committee (FOMC) commenced with its maturity extension program, popularly referred to as “operation twist.” The Fed’s actions have not injected new cash into the banking system; instead, they have influenced the shape of the yield curve as a result of the Fed’s reallocation of portfolio holdings from shorter to longer-dated securities. Major central banks have also strengthened currency swap lines amongst themselves to help ease bank funding pressures.

These active policy measures are not without justification. The consensus view is that Eurozone economies are likely to enter recession in 2012, adding additional uncertainty to the tenuous situation arising from Europe’s debt crisis. The increasingly pessimistic outlook for Europe is the base case for justifying additional support from central banks.

The uncertainties plaguing investors have also caused rising risk aversion among eurozone banks, as reflected in the level of overnight deposits eligible institutions have been placing with the ECB. This implies that banks prefer to hold short-term, liquid assets rather than lending to other financial institutions and creditworthy borrowers. Year to date through January 20, institutions have placed an average of €468 billion with the ECB, as compared to €314 billion in December 2011. This trend is clearly illustrated in Exhibit 1.

**Exhibit 1: An Active (Activist?) ECB**

![Chart](chart.png)

**What about the U.S.?**

Fed rhetoric remains dovish. This should not be a surprise, as U.S. economic data appears to be losing some of its recent steam. The questions running through investors’ minds are whether, and if so, when the Fed will begin another round of quantitative easing (commonly referred to as QE3). The FOMC has already implemented two rounds of quantitative easing. The first was initiated in November 2008, shortly after the demise of Lehman

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1 One basis point equals 0.01%.
2 The Fed implemented the original Operation Twist in the early 1960s. Although it has not assigned that title to its current maturity extension program, the media has, since both programs involve the same objective and tactics: to flatten the yield curve (lower longer-term interest rates) by changing the composition of the Fed’s balance sheet (reducing shorter-dated assets and buying longer-dated ones).
3 Quantitative easing typically involves a central bank creating new money in order to purchase financial assets.
Brothers, the Reserve Fund, and the near-collapse of AIG. The second (which seemed to have less of an impact on financial markets than the first) took place from November 2010 through June 2011.

The FOMC has two meetings scheduled for the first quarter of 2012. We think the Fed is unlikely to announce the initiation of QE3 at either meeting, although it may discuss the possibility of future unconventional easing. The FOMC will also begin to unveil widely anticipated forecasts from each committee member on future levels of the FOMC’s fed funds target rate (the Fed’s desired rate on overnight loans between member banks). It is likely, however, that Fed chairman Ben Bernanke will reiterate that QE3 remains a viable option. If economic conditions worsen or show no sign of improvement, the rhetoric is likely to intensify, and QE3 could become a reality in the second half of the year. We will look for additional clues out of the Fed’s first two meetings of the year.

**Looking Ahead**

The front end of the yield curve and money-market metrics, both heavily influenced by Fed policy, are likely to remain locked in place for the near future. The FOMC has clearly stated that it plans on holding its interest rate target exceptionally low for an extended period of time, going so far as to explicitly commit to low rates through mid-2013. Futures markets are painting an even more dovish picture. Fed funds futures are predicting the Fed will remain on hold through mid-2014, with an initial move tighter that summer. Three-month Libor remains range bound, and is currently capped just below 60 basis points, thanks to the many life lines central banks have put into place.

The U.S. Treasury curve, shown in Exhibit 2, tells a similar story. The front end is anchored by central bank policy. The more transparent the Fed’s policy intentions become, the greater the likelihood that the front end of the curve (represented by maturities of three years and less) will hold its flattening bias, with little incentive for investors to add positions. Price action at the long end of the curve will continue be driven by technicals and investors’ expectations of future growth, inflation and Fed policy.

Of course, investors should keep in mind that the views embedded in yield curves, and the forecasts of futures markets and central bank officials (even with the new transparency measures being implemented), are just that—forecasts. They are not set in stone, and will be adjusted as the economic climate shifts.

**Exhibit 2: U.S. Treasury Yield Curve**

Will the Fed Dangle a Carrot?

We, like many other market participants, believe there could well be another round of quantitative easing by the Fed, although the picture remains somewhat clouded by the European debt crisis and tepid U.S. economic growth. Despite the positive developments of recent months, there are sufficient risks to the outlook for Chairman Bernanke to dangle the carrot of another round of asset purchases designed to further expand the Fed’s balance sheet. The goal of that expansion, as always, will be to stimulate economic growth and foster improvement in the labor market.

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4 In central banking theory and practice, programs like quantitative easing and portfolio rebalancing are considered unconventional measures. Examples of conventional measures include targeting an interbank or similar lending rate, or paying a specified interest rate on reserves, in order to manage inflation expectations (and in the case of the Fed, to support the labor market).

5 Libor, the London Interbank Offer Rate, is a measure of the interest rate at which banks are willing to make short-term loans to each other.
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