Light at the End of the Tunnel? **15 August 2009**

Impacts of the Federal Reserve's interventions in the credit markets

Perhaps you've heard or used this line: "I see light in the tunnel – but I'm not sure if it's the end of the tunnel or an oncoming train." A recent *MSNBC* headline, "Analysis: Housing begins long, slow rebound" reminded us of that old saw when it recently grabbed our attention. The first line of the article confidently asserted, "It was – note the past tense – the worst housing recession anyone but survivors of the Great Depression can remember."[1] Unfortunately, the view from where we stand in mid-August 2009 doesn't allow us to put the housing recession in the past tense. While the recent news has been encouraging it must be understood within the context of various ongoing government interventions. We believe it is premature to declare a housing recovery as underway when several government support programs remain in place.

Many are aware of the first-time homebuyer tax credit that is providing some support for the housing market.[2] That tax credit is scheduled to expire at the end of November, although there are efforts underway to extend it into 2010. Then there are various foreclosure moratoria that have stopped or slowed the flow of foreclosed homes into the market; many of those moratoria have been voluntary on the part of financial institutions, although California recently enacted a 90-day moratorium effective 15 June 2009.[3, 4] There is speculation those moratorium initiatives have contributed to part of what is referred to as "shadow inventory" – homes withheld from the market due to low prices. "Shadow inventory has the potential to give us another leg down on home prices during the second half of the year," said Steven Wood, chief economist at Insight Economics. "It appears that there is a significant amount of shadow inventory in the form of bank owned properties, which will continue to grow with the rising in delinquencies."[5]

Lean On Me, When You're Not Strong…

Although less well understood, a perhaps more important source of support for the housing market is the Federal Reserve's unconventional intervention in long-term credit markets. Bill Withers' classic "Lean on Me" could be the Federal Reserve's new theme song for the Federal government's fiscal stimulus program. The first verse and refrain:

> Sometimes in our lives we all have pain

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[1] http://www.msnbc.msn.com/id/32249907/ns/business-real_estate/
[2] http://www.federalhousingtaxcredit.com/2009/index.html
[3] http://www.boston.com/business/articles/2009/02/14/lenders_agree_to_foreclosure_moratorium/
[4] http://cbs5.com/local/foreclosure.moratorium.2.1043671.html
[5] http://www.reuters.com/article/GCA-Housing/idUSTRE56U5YZ20090731

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We all have sorrow
But if we are wise
We know that there's always tomorrow

Lean on me, when you're not strong
And I'll be your friend
I'll help you carry on
For it won't be long
'Til I'm gonna need
Somebody to lean on

The Federal Reserve publicly announced in March it intended to purchase $300 billion in longer-term U.S. Treasury bonds (or "Treasurys") over the following six months.[6] Canada's CBC news service succinctly described the objectives behind the Fed's 18 March announcement to lend the U.S. Treasury $300 billion: "Buying up U.S. government securities is a new move for the Fed as it tries to stimulate the economy. Purchasing the Treasury debt would bolster their prices and reduce their yields, which would have the effect of making borrowing cheaper on debt, such as mortgages, tied to Treasury rates."[7] Macromedia Advisors estimates the Federal Reserve's actions have reduced 30-year mortgage rates 1 percent.[8]

The Federal Reserve's intervention in recent U.S. Treasury auctions was undertaken to keep a lid on interest rates while the federal government was in the process of raising over $1 trillion in capital to stimulate the U.S. economy. The Fed's concern, however, is that the federal government needs to borrow so much to fund its programs, it may need to raise interest rates to attract sufficient capital. The Federal Reserve can maintain demand for U.S. Treasurys by "buying" them, thereby keeping interest rates from rising as rapidly or high as they may have without the Fed's intervention.

We should point out that while it is popular to describe the Federal Reserve as "buying" Treasurys (e.g., a *London Telegraph* article described China as being "increasingly disturbed by the Fed's 'direct purchase' of U.S. Treasury bonds"[9]), the Fed cannot legally lend funds directly to the U.S. Treasury (i.e., purchase U.S. Treasurys) except to replace maturing bonds in its portfolio. Preventing the Fed's purchases of bonds directly from the Treasury is intended to maintain separation and independence between fiscal and monetary policy. The Fed can, however, purchase Treasurys from bond dealers as part of its Open Market Operations (OMO). So, when the Fed is described as buying U.S. Treasurys, it is generally doing so via a dealer network.

Unconventional Steps for Unconventional Times

China is not the only onlooker concerned by the Federal Reserve's actions in U.S. Treasury markets. For example, John Taylor, a Stanford University economics professor and senior fellow at the Hoover

[6] http://www.federalreserve.gov/newsevents/press/monetary/20090318a.htm
[7] http://www.cbc.ca/money/story/2009/03/18/fed-bonds.html
[8] http://www.economist.com/businessfinance/displaystory.cfm?story_id=14214898&fsrc=rss
[9] http://www.telegraph.co.uk/finance/financetopics/financialcrisis/5379285/China-warns-Federal-Reserve-over-printing-money.html

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Institution, remarked the Fed's move "raises huge questions about inflation and the independence of the Fed. This is unprecedented." Howard Simons, a strategist with Bianco Research was more blunt, saying, "It's as inflationary as hell."[10]

To underscore the unconventional nature of this intervention, the market largely considered such a program as unlikely even though the Fed had publicly discussed the potential action for months prior to the March announcement. For example, on 17 March – the day before the Fed's announcement – the *Wall Street Journal* ran an article predicting the Fed would not buy Treasurys: "The next logical step in the Federal Reserve's ongoing efforts to bring down the cost of credit in a broader effort to restore health to the economy is to buy U.S. Treasurys. But it's not a step the Fed is likely to take anytime soon, preferring to keep such a possibility in its back pocket."[11] Because it was unexpected, the announcement created "shock and awe" in the markets.

Sinister or Surgical?

Concern regarding the ultimate impact of the Federal Reserve's program has not lessened since it was announced. As of the end of July the Fed's purchases were approaching the $300 billion mark it set in March, nearly accomplishing in four months what it originally intended to take six months to complete. The magnitude of the program and timing of several of its purchases has prompted some analysts to interpret the Fed's execution of its program as an attempt to circumvent the rules prohibiting direct Treasury purchases and in essence "printing money." One of those analysts is Brian Benton; he estimates the Federal Reserve has effectively supported 38 percent of the U.S. Treasury sales volume in longer-term instruments since its March announcement.[12]

Another analyst, Chris Martenson, was curious about the sudden return of demand for seven-year Treasurys at the 30 July auction after two auctions for shorter-termed Treasurys earlier that week were met with only tepid demand. Martenson, tracked through the "paper trail" of specific Treasury bond purchases and subsequent sales to the Federal Reserve Bank in New York. The seven-year U.S. Treasury bonds that were purchased by buyers on 30 July were tracked to the Federal Reserve's books on 6 August as part of their Permanent Open Market Operations (POMO).[13, 14]

On the other hand (to utilize an overused economist's metaphor), veteran bond analyst John Janson sees no nefarious dealings in Martenson's findings – just efficiency on the part of the Fed:[15]

> "The principal reason for the Open Market Desk's purchase of so much of just one issue is simple and uncomplicated and it is not part of some Byzantine conspiracy. The Federal Reserve responds to that which the dealer community offers to them. Since the seven-year note was just auctioned the street would own far more of that issue in the narrow sector in which the Open Market Desk was operating today than of surrounding issues.

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[10] http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2009/03/21/BUGF16K7DF.DTL&type=business
[11] http://blogs.wsj.com/marketbeat/2009/03/17/will-the-fed-buy-treasurys/
[12] http://financialsense.com/fsu/editorials/2009/0804.html
[13] http://www.chrismartenson.com/blog/fed-buys-last-weeks-treasury-auction/23880
[14] http://www.newyorkfed.org/markets/pomo/display/index.cfm?showmore=1&opertype=orig
[15] http://acrossthecurve.com/?p=7671

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> "So to complete the operation quickly and cost effectively, they would opt to buy that issue. Pretty neat and surgical and quick."

Regardless of the intent, the net result is that the Fed's purchases are expanding the money supply at a time when the real economy is contracting – the very definition of inflation (see our *Perspective*, "What's in a Name?"[16]).

Growing Questions Could Undermine Federal Reserve Reputation

Beyond the concerns of whether or not the Federal Reserve and the Treasury are colluding in expanding the money supply, it seems there is little question that the aggressive Federal Reserve OMOs and somewhat unconventional policy tools being deployed have at least some in the financial media shaking their heads. For example, the *Financial Times* ran an article under the title "Wall Street benefits from Fed and Treasury" that said the following:[17]

> "On a steamy July morning in New York recently, the U.S. Federal Reserve, in accordance with announced plans, began purchasing $3 billion in government bonds maturing between February 2021 and 2026. Prices rose in anticipation of the Fed move. Some two hours later, the U.S. Treasury auctioned $39 billion in five-year notes. Prices for government debt dipped on expectations of increased supply.
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> "So goes another day in the market for U.S. government securities. The Fed buys debt to support the markets while the Treasury auctions debt to pay for government spending. Wall Street stands in the middle, taking its cut every time. In recent months, that cut has been sizeable.
>
> "The new world of government debt trading has been marked by the widening of spreads between bid and offer prices – the stuff of Wall Street profitability – following the demise of Lehman Brothers. There are fewer primary dealers through which government securities are bought and sold – 18 compared with 31 a decade ago – and they are more likely to focus on handling customer orders than putting their own capital at risk…."

Not to be outdone, *Bloomberg* offered this recent provocative headline "Bailout Banks Buying Treasurys Help Keep Rates Low."[18]

Federal Reserve Intervention in U.S. Treasurys Losing Traction?

Despite all the smoke that may or may not indicate a fire, to us the most significant development in the Fed's attempts since March to cap interest rates is that those efforts may be losing their effectiveness. A recent *MarketWatch* article reported the market's expectation heading into the August Federal Open Market Committee (FOMC) meeting was the Federal Reserve would neither extend nor expand its six-month, $300 billion Treasury purchase plan. Among reasons cited for allowing the program to end, "individual Fed officials have said they are uncomfortable with extending the program any further,

[16] http://www.delphiadvisors.com/perspectives/A-Name.pdf
[17] http://www.ft.com/cms/s/0/ffa60e50-7f8c-11de-85dc-00144feabdc0.html
[18] http://www.bloomberg.com/apps/news?pid=20601087&sid=aucooSmI6UQQ

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recognizing concerns that the Fed's actions carry the risk of appearing to support unsustainable spending by the government…'We have come as close as we dare to the line between acceptable and unacceptable risk in this regard,' said Dallas Fed president Richard Fisher in late July."[19]

The *Wall Street Journal* added its voice to pre-FOMC meeting speculation about the program, indicating the Federal Reserve officials themselves are questioning the program's effectiveness at taming long-term interest rates, particularly in light of persistent investor concern over the downstream impacts of significantly expanding the money supply sparking inflation:[20]

> "The decision about the Treasury bond purchase program is the most pressing on the agenda [of the August FOMC meeting]…Officials aren't convinced it was highly effective at bringing down long-term interest rates. Moreover, they worry about the costs of continuing the program. Investors might worry that more bond purchases will cause inflation by making it easier for the government to run big budget deficits or make it tough to raise interest rates later."

Investors Business Daily added the following regarding the expected Federal Reserve's actions toward the program:[21]

> "I don't think there is any likelihood [the $300 billion Treasury purchase program] is going to be continued," said [former Fed Board Governor Lyle] Gramley. "With continued worries in markets that at some point the Fed will have to monetize the debt, it is better to not be seen as buying longer term Treasuries under these circumstances," he said.

Personally, we found *Reuters*' pre-FOMC meeting assessment of the program the most insightful:[22]

> "An onslaught of U.S. government debt issuance, coupled with signs the battered economy may be stabilizing, has meant the Federal Reserve's purchases of Treasurys are having a declining impact on bond prices. The huge U.S. government borrowing requirement and the declining need for a safe-haven investment ***has begun to overwhelm the central bank's efforts to keep yields down*** [emphasis added], hurting its ability to keep a lid on consumer borrowing rates in its effort to stimulate economic growth. The Fed has purchased more than three quarters of the $300 billion of longer-dated Treasurys planned in its six-month buying spree started in March. So barring a surprise extension of the Fed program, many bond investors have already consigned the central bank's government bond buys to history."

Getting Out While Ahead

In short, the *Reuters* analysis suggests the Federal Reserve is cutting its losses. The looming size of growing public debt, along with signs the U.S. economy may be stabilizing (which means increased capital demand to fund private investment), implies the Federal Reserves ability to control long-term interest rates will wane from this point forward. To continue affecting long-term rates, the Fed would

[19] http://www.marketwatch.com/story/fed-seen-ending-treasury-buying-as-recovery-looms-2009-08-07
[20] http://online.wsj.com/article/SB124951396648209263.html?mod=dist_smartbrief
[21] http://www.ibtimes.com/articles/20090809/fed-to-dampen-rate-hike-talk-halt-treasury-buying.htm
[22] http://www.reuters.com/article/ousiv/idUSTRE5746BB20090805

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have to dramatically increase the size of its future Treasury purchases. However, the required expansion in the money supply to enact such an expanded program could further fuel inflationary concerns by both domestic and foreign investors and counteract the Federal Reserve's purchases. Instead, it seems the Fed's calculus was that it is better to let the program end and *be perceived as being effective* rather than trying to extend or expand the program and risk failing to contain long-term rates, which could severely damage market psychology.

It should be noted that the Federal Reserve served the markets a mild surprise at the August FOMC meeting; while the Treasury purchase program wasn't *expanded* ($300 billion will still be bought as originally planned) the ending date was *extended* by one month (ending in October instead of September).[23] Many news outlets and pundits interpreted this move as a sign of the Fed's confidence in the stabilizing U.S. economy. Some went as far as to speculate that the Fed's decision to not expand the program signaled the start of its exit strategy – i.e., removing its monetary stimulus.[24]

Our own view is somewhat different, and we believe the one-month extension is more evidence for our contention: the Federal Reserve recognizes its ability to affect markets by this means is diminishing. Extending the window in which it can intervene provides for a more gradual market transition in the Federal Reserve's actions to cap long-term interest rates; it also maintains the perception that the Fed can still affect the markets. For example, long-term treasury rates were already heading higher on weak demand early in the week of the August FOMC meeting. Once the single-month extension was announced, however, rate increases moderated. *MarketWatch* filed this report on the bond market prior to and after the FOMC announcement:[25]

> "Treasury prices improved on Wednesday, though long-term yields remained higher, after the Federal Reserve said it would slow down its purchases of U.S. debt, keeping a steady buyer in the bond market a little longer than investors previously expected. The market was lower before the decision, as the government had to pay more than expected to entice investors to buy a record amount of 10-year notes up for auction. Yields on the current 10-year note remained higher by 3 basis points to 3.69 percent, after touching 3.83 percent before the Fed decision was released. A basis point is 0.01 percentage point. Bond prices move inversely to their yields."

Reuters reported the market action in this way: "Longer maturity U.S. Treasury yields were stable after climbing overnight on disappointment that the Fed said it would slowly wind down its government bond purchasing program by the end of October, leaving dealers to wonder how the market would absorb heavy upcoming supply."[26]

Implications for the Forest Products Sector

The seven-year and longer Treasurys are particularly critical in defining inflation expectations for investors. At the very least it seems apparent to us that without the Federal Reserve's intervention in

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[23] http://www.federalreserve.gov/newsevents/press/monetary/20090812a.htm
[24] http://www.theglobeandmail.com/report-on-business/us-fed-signals-stimulus-exit-plan/article1249667/
[25] http://www.marketwatch.com/story/treasurys-up-before-10-year-note-auction-fomc-2009-08-12?siteid=rss&rss=1
[26] http://www.reuters.com/article/usDollarRpt/idUSSP29231320090813

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Treasury auctions, there would be little demand, bond prices would already be lower, and interest rates would already be rising as a result. A *MarketWatch* article says as much: "With the Fed no longer a constant, large buyer of Treasury notes and bonds, benchmark yields and mortgage rates will likely rise."[27] Indeed, even the confirmation the Fed was going to end its program already began to affect mortgage markets:[28]

> "Home mortgage rates were mixed this week as the Federal Reserve began easing away from its repurchase of Treasurys. The average 30-year fixed rate mortgage inched up to 5.67 percent from 5.65 percent the week prior, and the 15-year fixed fell to 4.93 percent from 4.97 percent, according to the weekly national survey from Bankrate.com. Mortgage rates have held within a narrow range for almost two months, despite some economic improvement, the [Bankrate] report noted. 'With the Federal Reserve beginning to wean the markets from its repurchases of Treasury debt, there will be less to restrain mortgage rates if the economic data continue to improve,' the report said. Bond yields tend to influence mortgage rates."

While rising interest rates for any term of Treasury bond would make a lasting recovery much more difficult, increasing long-term rates imply higher levels of inflation in the future as well. I.e., anyone lending money in an inflationary environment will be repaid with less valuable currency in the future due to inflation, and so must receive a higher rate of interest to be compensated for that inflation risk. Inflationary expectations will affect both personal and business investment decisions as businesses and individuals adapt to cope with the deleterious impacts of an inflationary environment.

We believe that ultimately the lack of lenders, coupled with growing global debt, will require interest rates to increase despite the best efforts of the Federal Reserve to keep them low; rising rates will send the economy back into a recession in late 2010 or early 2011. Unfortunately for the Building Products industry, longer-term interest rates will be the first part of the yield curve to be influenced by the termination of the Federal Reserve's Treasury buying program; this, in turn, will cause mortgage rates to climb, creating yet a new hindrance to ultimate recovery in the housing market. In the case of housing we view this as a temporary setback that will slow the eventual housing recovery, extending the bottom of the market from mid-year 2009 (as many are hoping) to early 2010.

We see housing picking up over the last three quarters of 2010 before stalling as the U.S. economy slips back into recession. In 2011 relatively low unsold housing inventories and good affordability due to home price declines will keep housing from crashing during the next downturn. However, this points to a delayed recovery from what many are calling for and a hitch on the way back to better days.

[27] http://www.marketwatch.com/story/fed-seen-ending-treasury-buying-as-recovery-looms-2009-08-07
[28] http://money.cnn.com/2009/08/13/real_estate/mortgage_rates/index.htm?section=money_latest

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