Market Insights

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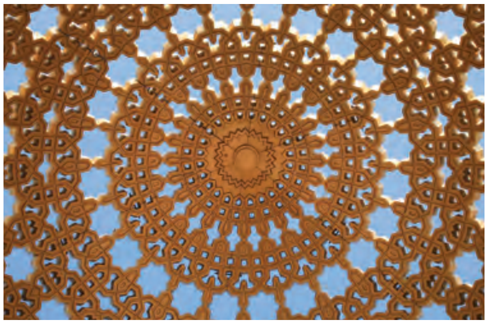

Delicate Balance Required Between Growth and Policy Normalization

By Thomas D. Higgins, PhD, Global Macro Strategist, Standish Mellon Asset Management Company LLC ("Standish")

Higgins says policymakers in the developed world need to proceed cautiously with policy normalization as they have little ammunition left to battle renewed weakness in aggregate demand.

Executive Summary

Over the second half of the year, central bank authorities in the U.S. and Europe will begin transitioning away from some of the emergency policy measures that were adopted at the height of the financial crisis. In the U.S., the Federal Reserve's (the Fed) second round of quantitative easing (QE2) will end in June, and the European Central Bank (ECB) is considering additional rate hikes to tame inflation. Standish Global Macro Strategist Tom Higgins argues that U.S. interest rates are unlikely to spike at the conclusion of QE2, as the market has already priced in the completion of Fed purchases and that pressure on bond yields is likely to increase only when the Fed begins shrinking its balance sheet and selling Treasuries. This, he says, they are unlikely to do for as long as the U.S. labor market remains tight and wage pressure on inflation remains low. While the ECB has already raised interest rates by 25 basis points (bps) this year, Tom argues that moves toward fiscal consolidation in the eurozone are likely to dampen economic growth, lessening the likelihood that the ECB's interest rate hiking cycle will extend into 2012. Policymakers in the developed world, he says, need to proceed cautiously with policy normalization as they have little ammunition left to battle renewed weakness in aggregate demand.

Inflation and Central Bank Policy

The recent surge in global commodity prices has raised the specter of inflation and sparked a debate about the accommodative stance of central bank policy in the United States and Europe. The Commodity Research Bureau's (CRB) spot index is up more than 30% over the past year and headline inflation has been drifting higher in advanced and emerging market economies alike.[1] Although part of the increase may be explained by temporary factors such as geopolitical risk in the Middle East and its impact on oil prices, there are also signs that broader inflationary pressures may be building.

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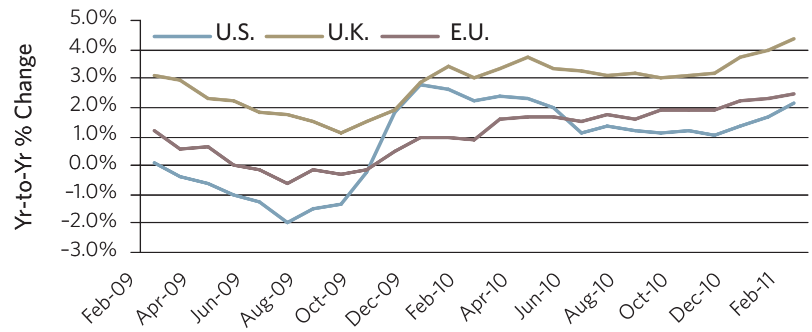
1 Bloomberg, as of March 31, 2011.

May 2011

Headline Inflation Begins to Creep Higher (Consumer Price Index)



Source: Standish, using data from the U.S. Bureau of Labor Statistics, U.K. National Statistics Office & Eurosat, as of February 28, 2011.

While we believe some reduction in the level of accommodation may be appropriate at the present time, we think it is premature to begin aggressively discounting an interest rate hiking cycle given the risks that hang over the global economy.

As a result, investors have begun to question whether the emergency policy measures which were adopted at the height of the financial crisis are still warranted in the current environment. The ECB has responded to inflation concerns by hiking its benchmark interest rate by 25 basis points (bps) to 1.25% at its April meeting and the markets have already priced in two more ECB rate hikes by year end. Although U.S. interest rate increases are probably further in the future, the Federal Reserve has indicated it plans to conclude its purchases of Treasuries as part of QE2 in June. The market has priced in two 25 bps Fed rate hikes during the first half of 2012.

While we believe some reduction in the level of accommodation may be appropriate at the present time, we think it is premature to begin aggressively discounting an interest rate hiking cycle given the risks that hang over the global economy. Below we will examine the implications of these policy shifts at the major central banks for the global economy and fixed income markets.

Will the End of QE2 Push Rates Sharply Higher in the U.S.?

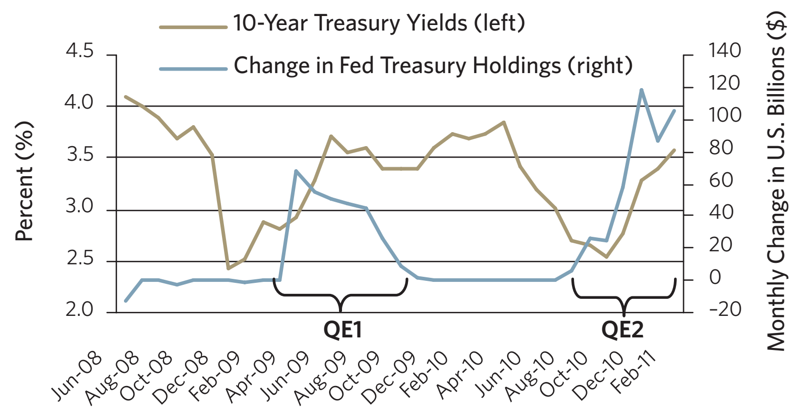
There has been speculation that long-term interest rates will rise abruptly with the end of the Fed's QE2 program in June. On the surface, this would appear to make sense since the Fed will have effectively absorbed all of the new Treasury supply that hit the market during the first half of 2011. Yet, digging a little deeper, we believe that there are at least four reasons why rates are unlikely to spike on June 30 when the Fed completes its purchase plan:

1. The market has known about the end of QE2 since the program's inception and has fully priced in the completion of the Fed purchases in June.
2. The amount of supply the Fed has removed from the market is more important to the level of bond yields than its participation in the Treasury auctions.
3. The central bank is expected to continue to reinvest the proceeds of maturing mortgages in its portfolio back into U.S. Treasuries.
4. The economic fundamentals do not yet justify sharply higher interest rates.

On the first point, investors are forward-looking and we believe they have already fully priced in the end of QE2. This expectation is based on looking back at the implementation of the first and second rounds of quantitative easing. In both instances, interest rates declined in anticipation of the Fed's Treasury purchases and then rose as the program was executed. Indeed, between November 4, 2010, when the Fed first announced QE2 and April 8, 2011, interest rates have risen more than 100 bps to 3.5%.[2] This increase is partly due to improving economic fundamentals and stabilizing inflation, but may also be attributable to the conclusion of QE2.

Much of the decrease in Treasury yields that occurred as a result of QE should persist as long as the Fed maintains the size of its balance sheet.

U.S. 10-Year Treasury Yields and QE Purchases



Source: Standish, using data from the U.S. Treasury Department, as of February 28, 2011.

On the second point, the Fed's participation in the Treasury auctions has had less of an impact on Treasury yields than its removal of supply from the market. Recent academic research supports this conclusion. Two Fed economists, Stefania D'Amico and Thomas King, quantified the effects of QE in their paper, "Flow and Stock Effects of Large-Scale Treasury Purchases." They found that each Fed purchase operation, on average, caused Treasury yields to decline 3.5 bps on the days when the purchases occurred (the flow effect), but that the decline in yields was quickly reversed the following day.[3] By contrast, the removal of supply associated with the QE program as a whole resulted in a persistent downward shift in the yield curve of as much as 50 bps (the stock effect) with the largest impact evident in the 10-15 year part of the curve. Thus, much of the decrease in Treasury yields that occurred as a result of QE should persist as long as the Fed maintains the size of its balance sheet.

2 Bloomberg analytics historical data.

3 Stefania D'Amico and Thomas King. "Flow and Stock Effects of Large-Scale Treasury Purchases." Finance and Economics Discussion Series. Federal Reserve Board. Washington, DC. September 2010.

On the final two points, we believe the Fed will continue to reinvest the proceeds from its $945bn mortgage portfolio into Treasuries, which could amount to between $8bn and $12bn each month at current interest rates. Once the Fed begins shrinking its balance sheet and selling Treasuries, we believe the pressure on bond yields will increase. However, this is only likely to occur when a tighter U.S. labor market begins to exert upward pressure on inflation. The core personal consumption expenditures (PCE) deflator — the Fed's preferred inflation gauge — currently stands at just 0.9%, which is well below the central bank's 1.5% to 2.0% implied target range.[4]

We believe the short end of the Treasury yield curve will begin to rise later this year as investors anticipate interest rate increases by the Fed during the first half of 2012.

Even if, as we suspect, the market is correct in discounting interest rate hikes by the Fed in the first half of next year, it seems highly unlikely that the central bank will begin selling any of the assets it has accumulated until the tightening cycle is well advanced. Fed Vice Chairman Janet Yellen outlined one possible exit strategy in which the central bank completes its purchases of Treasuries under QE2 in June 2011 and then waits a full year before beginning the process of winding down its balance sheet. Yellen speculates it could take four or five years before the Fed's balance sheet is returned to its pre-crisis trend line.[5] Nevertheless, we believe the short end of the Treasury yield curve will begin to rise later this year as investors anticipate interest rate increases by the Fed during the first half of 2012. Our model suggests this will result in some flattening in the spread between 2-year and 10-year Treasuries.

European Central Bank Policy: One Size Fits All?

The European Central Bank raised interest rates for the first time in three years at its April policy meeting. Though the magnitude of the increase was small at 25 bps, its implications are far reaching for the peripheral European economies, which are already struggling to grow as they attempt to trim their fiscal deficits.

Homeownership is high and variable rate mortgages dominate in countries such as Greece, Portugal, Ireland and Spain. Indeed, the percentage of mortgages tied to short-term interest rates is 70% or higher in these economies, meaning consumers are sensitive to changes in interest rates. The effects of higher rates are compounded by the fact that many of the peripheral European economies are still in the midst of unwinding credit bubbles. At the same time, the widening differential between short-term interest rates in the U.S. and Europe has caused the euro to strengthen more than 10% versus the U.S. dollar during the first quarter. This makes European exports less competitive in overseas markets and closes one more avenue of growth to the peripheral European economies.

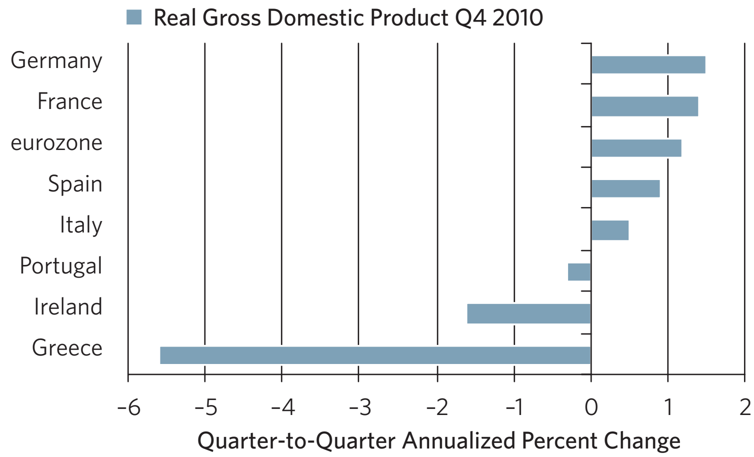
4 U.S. Bureau of Economic Analysis, as of March 2011.

5 Janet L. Yellen. "Unconventional Monetary Policy and Central Bank Communications." The U.S. Monetary Policy Forum. New York, NY, February 25, 2011.

One might question why the ECB would choose to raise rates at a time when so many countries in Europe are doing so poorly. The answer is two-fold. First, unlike the Fed which has a dual mandate of balancing price stability with full employment, the ECB has a strict 2.0% inflation ceiling. The eurozone-harmonized consumer price index (CPI) stood at 2.6% in March. Second, core Europe, which makes up a greater share of eurozone GDP, is still expanding at a healthy clip. The French and German economies alone make up roughly half of eurozone GDP compared to only 15% for Greece, Portugal, Ireland and Spain combined.[6]

We suspect that the ECB's early rate hike was meant to add some urgency to the negotiations on the outstanding issues surrounding the European Financial Stabilization Fund and the European Stabilization Mechanism.

Diverging Economic Performance in Europe



Source: Standish, based on data from Eurosat, as of March 31, 2011.

The ECB may also have an ulterior motive in raising interest rates. Central bank officials have noted that they are uncomfortable providing unlimited liquidity to banks in the peripheral European economies as a stop gap measure until European leaders get their act together and develop a long-term solution to Europe's sovereign debt crisis. We suspect that the ECB's early rate hike was meant to add some urgency to the negotiations on the outstanding issues surrounding the European Financial Stabilization Fund and the European Stabilization Mechanism.[7]

Looking ahead, we believe that moves toward fiscal consolidation will dampen economic growth in the eurozone and lessen the likelihood that the ECB's interest rate hiking cycle will extend into 2012. We expect this to result in a narrowing of the differential between U.S. and European short-term interest rates in the second half of 2011. This could also be accompanied by some weakening of the euro exchange rate versus the U.S. dollar.

6 Eurostat, as of April 2011.

7 See Thomas D. Higgins, "Eurozone Partners Likely to Stay in Marriage for Better or for Worse," BNY Mellon Asset Management, April 2011.

Some Policy Normalization Is Appropriate

It has been more than two years since policymakers in the U.S. and Europe adopted emergency measures, such as record low short-term interest rates and quantitative easing to combat the 2008-09 financial crisis. Today, with the global economy on firmer footing and inflation picking up, some normalization of monetary policy is deemed appropriate.

However, we believe policymakers need to proceed cautiously given inflation remains subdued in most of the advanced economies and they have little ammunition to battle any renewed weakness in aggregate demand. The Fed has demonstrated a willingness to tolerate a little more inflation in the short term in the belief that it can always raise interest rates, but its ability to cut rates is limited given the zero bound. By contrast, the ECB seems prepared to shoot first and ask questions later when it comes to inflation. This may prove to be a dangerous game to be playing, particularly given the fragility of some of the economies in peripheral Europe.

Thomas D. Higgins, PhD, Global Macro Strategist

Tom is the Global Macro Strategist for Standish. He is responsible for developing views on the global economy and making relative value recommendations among global bond markets, currencies, and sectors. Before joining Standish in 2010, Tom was employed as the Chief Economist for Payden & Rygel Investment Management in Los Angeles and served as International Economist at The Conference Board. Tom received his Ph.D. and M.A. degrees in Economics from Fordham University and holds a B.A. in Economics from Drew University. Tom has eighteen years of experience analyzing financial markets. He is a member of both the American Economics Association and the National Association of Business Economics (NABE). Tom was President of the Los Angeles Chapter of the NABE from 2006-2007. Higgins is a past board member of the Los Angeles Economic Development Corporation and the California Council on Economic Education. Tom was the 2010 Recipient of the Robert T. Parry Award for Exemplary Contributions in the Field of Economics.

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