



Stop Front-Running the Fed

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A change of mindset is in order for bond investors, who must recognize that it is no longer wise to “front-run” monetary policy by purchasing the same bonds the Federal Reserve is targeting with its latest round of quantitative easing (QE2).

During the so-called “QE1,” completed in March of this year, front-running the Fed’s bond-buying intention was a profitable pursuit, but, as I’ll explain, it is not this time around.

Policy makers at the Treasury Department and at the Fed may have painted themselves into a corner, making their respective policy objectives mutually dependent for the foreseeable future. Specifically, the Treasury Department needs to extend its liability structure without breaking the federal budget, which it must do by selling longer-term bonds at today’s ultra-low interest rates. At the same time, recent monetary policy at the Fed creates disincentives for investors to buy longer-term bonds at today’s interest rates, requiring the Fed to provide an alternative source of demand for these securities.

Since the FOMC statement regarding its latest asset purchase program makes clear that the Fed intends to accumulate longer-term U.S. Treasury securities in the coming months, it is reasonable to assume that QE2 includes a hidden agenda, whereby the Fed serves as a buyer of last resort for U.S. government bonds that might not catch a bid from private market investors, at least not at prices the Treasury Department can afford to accept.

If that’s the case – and I believe it is – the Fed is looking to keep long-term bond prices artificially high, for reasons I’ll explain in more detail. Bond investors may be wise to let the Fed take the lead with QE2, waiting for higher yields before following the Fed’s example.

Front-running then and now

The Federal Reserve surprised no one when it announced plans for a second round of quantitative easing on November 3rd. Its intent to launch another asset purchase program had already been telegraphed by various Fed governors, beginning with a speech by Ben Bernanke, the Fed chairman, on August 27th at a speech in Jackson Hole, Wyoming.

Investors’ immediate reaction to that speech was to do what they did first time the Fed embarked on a major asset purchase program in the spring of 2009: Buy what the Fed is



buying. In the two days immediately following Bernanke's comments, U.S. government bonds rallied strongly, with yields dropping by 19 basis points on 10-year Treasury bonds and 16 basis points for 5-year notes.

This time, however, my careful reading of the Fed's official statement regarding its plan, which calls for it to purchase up to \$850 billion in newly issued U.S. Treasury securities over the next eight months, revealed an important difference from QE1. Specifically, every reference to the securities the Fed intends to accumulate during the upcoming program is preceded by the adjective "longer-term." An attachment to the official statement includes an outline of the Fed's purchase intentions by maturity range, as follows:

<u>Maturity Range</u>	<u>Allocation</u>
1.5 – 2.5 Years	5%
2.5 – 4.0 Years	20%
4.0 – 5.5 Years	20%
5.5 – 7.0 Years	23%
7.0 – 10.0 Years	23%
10.0 – 17.0 Years	2%
17.0 – 30 Years	4%
TIPS	3%

Source: Federal Reserve statement, November 3, 2010

Note that 75% of the Fed's asset purchase program is earmarked for bonds maturing in four years or more, while just 5% of the program involves bonds maturing in 2.5 years or less. It's uncanny how the bond portfolio the Fed intends to accumulate over the next eight months represents a near-mirror image of the current liability structure of the U.S. government, which is very heavy on shorter maturities and shockingly light on longer-term debt.

Indeed, the Treasury Department may have put itself in a very difficult position in recent years by financing the federal balance sheet with too much short-term debt. Out of \$8.3 trillion of total sovereign debt outstanding, \$5.2 trillion, or 63%, must be rolled over within the next three years. This lopsided balance sheet binds the sustainability of the U.S. economy to the kindness of foreigners, because the savings and asset preferences of U.S. investors are insufficient to handle the volume of Treasury securities that must be issued each year to replace existing bonds as they mature and fill the further gaps produced by persistent federal budget deficits.

Treasury Secretary Timothy Geithner must surely be aware of the potential hazards of America's un-balanced balance sheet. Yet re-weighting the nation's liability structure with



longer-term debt may be easier said than done, in no small part because current monetary policy at the Fed disincentivizes ownership of longer-term U.S. government bonds.

For example, who might find value in a 30-year asset yielding less than 4.3% now that the Fed has explicitly shifted to a pro-inflation regime? Who among foreign investors might volunteer for a sub-3.0% yield on a 10-year bond denominated in a depreciating U.S. currency? How many retirees can live on the 1.3% “windfall” from five-year Treasury notes? And who might fill the very large void that will emerge in the market for Treasury debt whenever commercial banks decide to invest their growing excess reserves in loans rather than more government bonds?

The very real possibility that investors might demand higher interest rates on U.S. government bonds before Geithner can roll the nation’s short-term debt into longer maturities drives QE2’s hidden agenda. The Treasury Department needs someone to purchase large quantities of longer-term government bonds – \$850 billion worth – at today’s historically puny yields, because traditional buyers for this debt – commercial banks, foreign central banks, and retirees – may be losing their appetite.

When the Fed embarked on QE1, the initiative represented a voice of reason in a panicked marketplace. Mortgage-backed bonds were overshooting to the downside, along with nearly every other risk-based asset. The Fed’s bold asset-purchase program created an incentive for other buyers to return to the market. Investors who followed the Fed’s lead, or better yet, jumped in front of it, earned spectacular profits.

The impetus for QE2 is quite different, however. Today, the Fed is buying assets that may have already overshot to the upside. Its objective is less to correct a mispricing in the asset markets and more to sustain a mispricing long enough for the Treasury Department to take advantage.

Don’t be fooled by the Fed’s eagerness to purchase longer-term government bonds. Rising inflation and a depreciating currency are reasons to sell this stuff, not buy it. Let the Fed take the first loss on the bonds that Geithner is trying to peddle at microscopic yields.

Remember that eventually market conditions will force the Fed to stop expanding its balance sheet through QE2. That will be the time to buy long-term government bonds – on the cheap.

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