

# QE Taper. For Real? Fed Interest Rate Policy.

QE Taper, for real?

- The Fed is reducing UST purchases from 45 billion USD to 40 billion USD per month, a 11.1% reduction. It is reducing Agency MBS purchases from 40 billion USD to 35 billion USD, a -12.5% reduction.
- US treasury issuance is shrinking at roughly 18% YOY due to an increase in tax receipts as the US economy recovers. Agency MBS issuance is also slowing, by about 30% YOY as banks underwriting standards have tightened and asset quality has improved to the extent that banks are willing to retain mortgages on balance sheet.
- This implies that despite spending fewer dollars on buying bonds, the US Fed is buying up an increasing proportion of new issuance. This is hardly tapering.

Short term interest rates, low for how long? The market expects rates to be kept low till 2015. Its possible that rates may be kept low for even longer. Why?

- Its possible that all that bond buying by the Fed was to maintain a respectable bid to cover ratio at auction, and not to reflate the economy. Why? Surely the Fed would understand that banks lend out of capital and not liquidity and all the LSAPs would do is liquefy the financial system, not provide it with capital.
- Treasury relied on the Fed to keep yields low so that it could refinance itself cheaply.
- The Fed balance sheet, at 4 trillion USD has reached critical limits making general prices potentially unstable. The Fed needed to find a less risky means of refinancing Treasury.
- This month, Jan 2014, will see the inaugural issue of Treasury FRNs (floating rate notes). Treasury needs to fund itself longer than the T Bills market. It intends to issue 2 and 3 year paper. It understands that

investors will only provide longer term financing if they do not have to take on duration risk. FRNs are ideal for both lender and borrower.

- This provides the Fed with a cheaper and less risky way of suppressing Treasury's interest expense. The Fed only needs to keep short rates floored at zero.
- The risk to this strategy is that whereas fixed rate debt can be inflated away, floating rate debt becomes more expensive under inflation as rates react to inflation expectations.
- Under the above thesis, interest rates will be kept low for another 3 years or more. Unless inflation perks up.

What about long rates?

- Inflation expectations are one of the important determinants of UST yields. US inflation numbers are low. The headline number is 1.2%, down from 1.8% a year ago. Core inflation, which excludes volatile and transitory items such as food and energy are at 1.7%, down from 1.9% a year ago. Considering that shelter is a large item in the CPI, and US housing and mortgage rates are rising, we should expect to see much slower inflation in the larger cash flow items (that is ex owner equivalent rent, which is not a cash flow item.) CPI ex shelter has fallen from 1.4% a year ago, to 1.0% today. Again, a 4% 10 year UST yield is not a foregone conclusion.
- However, given that the US Fed is a large buyer of treasuries, the eventual withdrawal of QE is likely to steepen the term structure.
- Take note of the US trade balance which has been recovering quite steadily. US manufacturing is rebounding, an ageing population is consuming more services and less goods, more production is being re-shored and shale gas and fracking technology is reducing reliance on energy imports mean that the US will export less USD, less exported USD will mean less demand for US treasuries, implying a steepening of the term structure.

Food for thought...