RENMAC
RENAISSANCEMACRORESEARCH

September 10, 2012

Wallace's Daily Policy Debrief

Today:

1) **Weekly Central Bank Report – Tom Gallagher**
2) **Policy Calendar**

FOMC Outlook: QE or Not QE Isn't The Only Question

There is still a wide range of possible outcomes. We get the impression many investors regard the Thursday outcome as nearly binary – if QE, then risk-on; if not, then risk-off. We think it will be a more complicated outcome and one whose significance may not be fully appreciated on the first read.

Will the Fed embark on more QE?

This is the threshold question for markets, and we think odds favor it, but we don't want to go into the "done deal" camp.

- The arguments for it: the data, especially Friday's jobs report, don't meet the "substantial and sustainable" recovery standard laid out by the Fed; and other options aren't substantial enough to provide meaningful easing.

- But the reasons it's not a done deal: the Fed may feel changing the rate guidance is sufficient; expanding the balance sheet is the most politically controversial option and thus shouldn't be adopted during the election campaign; and changes in asset purchases could wait until the current Operation Twist ends in December.

- We think the former arguments are more persuasive. The Fed has been doing a long windup for this pitch; failure to act in a meaningful way would hurt the Fed's credibility. To the extent the market has been patient it's because it's given Bernanke time to get a consensus of the FOMC behind the next course of action. The rate guidance is priced in, so failure to undertake more asset purchases would cause a market sell-off. Still, we'd put the odds of more QE at just 2 in 3.

What form could more QE take?

There are many possibilities here. On one point there is a broad consensus among Fed watchers – any more QE will include MBS as well as Treasuries. **But it's important to remember that the Fed is already buying long-term Treasuries** (it is almost halfway through the extended Operation Twist announced in June, $267 billion of purchases offset with the same amount of sales of short-term Treasuries; that is, the Fed is already planning on buying $45 billion of long-term Treasuries each month until year-end, and

Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher|Kevin Nealer|Joel Shin|Eric Melby|Todd Mariano
policy@renmac.com

based on the "stock effect" this is already priced into financial markets). It's not at all clear how the Fed would handle the unfinished part of Operation Twist in a new QE program. Then there are the questions of whether new QE would be of a set amount or open-ended, and if open-ended whether the amount would be set at each meeting or whether regular amounts would continue until certain macro targets are achieved.

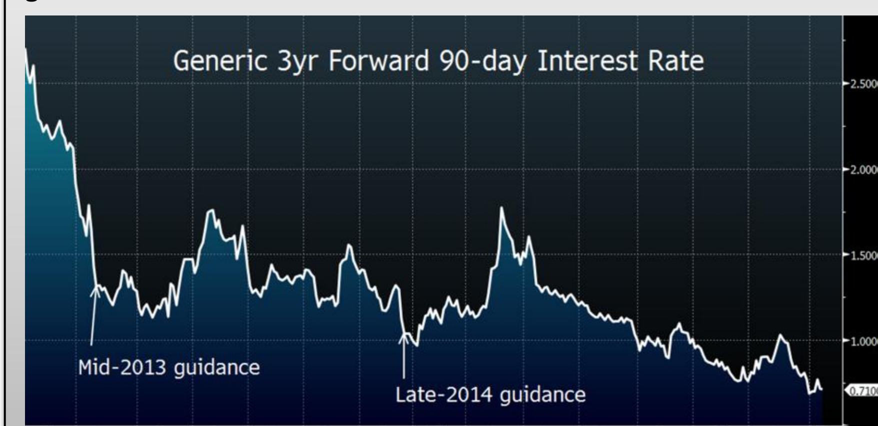
So let's consider a few possibilities. An aggressive option here would be to suspend Operation Twist and announce substantial monthly purchases of both Treasuries and MBS on an open-ended basis. For example, the Fed could announce $100 billon of monthly purchases of long-term assets split between Treasuries and MBS. And it would stop selling short-term Treasuries. But that would suggest the Fed thinks how it finances its long-term Treasury purchases (sterilized via short-term sales or not sterilized as bank reserves expand) matters, and they've suggested just the opposite. To be clear on this approach, the only new purchases would be monthly amounts in excess of $45 billion.

A less aggressive option, and one that we find quite plausible, would be to launch MBS purchases on an unsterilized basis alongside a continuation of Operation Twist (so MBS purchases would be unsterilized but Treasuries would be sterilized). **The MBS purchases could be a fixed amount to get to year-end, when Operation Twist ends, thus setting up December as a time for the Fed to refashion its QE program in a more fundamental way.** A variation on this could be an open-ended MBS-based QE program, again to get the Fed to December. **These latter options could involve as much in asset purchases but less of an increase in the Fed's balance sheet than the more aggressive option.**

Thus we see some risk that markets could be disappointed by the size of the expansion of the balance sheet the Fed may announce Thursday. Equities, commodities, and the dollar have responded more in the very short run to moves that expand the balance sheet (QE) versus those that don't (rate guidance, maturity extension through Operation Twist). **We don't share the underlying notion that expansion of the balance sheet matters; we haven't seen any evidence that the excess bank reserves that finance the asset purchases do anything other than sit at the Fed and earn the interest on excess reserves**.

What about the date for the guidance on near-zero rates?

There is little scope to lower near-term rates through extended rate guidance



The minutes all but said the date for possible rate hikes needed to be moved, but the Fed would wait until it next updated its interest rate projections. The Fed first had a long-term guidance on near-zero rates in August 2011, when it had a mid-2013 guidance (a roughly 2-year commitment); then in January 2012 it pushed that out to late-2014 (a nearly 3-year commitment). Two-year notes have been in a range of 20-30bp since then, and are at 25bp now. Since August 2011 the Fed has promised to keep rates near zero for the length of a 2-year

Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher | Kevin Nealer | Joel Shin | Eric Melby | Todd Mariano
policy@renmac.com

note, so this range is essentially the result of a term premium and probably the interest rate on excess reserves (it has been 25bp throughout this period).

If the Fed pushes out the guidance to mid-2015, that's close to the 3-year commitment made early this year. **This chart on the generic 3-year forward 90-day rate strongly suggests that the market already expects such a path for fed funds** (it's now much lower than it was when the Fed adopted the late-2014 date in January).

What about revising the language in the rate guidance?

It seems very likely that the change in the rate guidance won't be limited to an extension of the date. Both the minutes and Bernanke's Jackson Hole speech hinted at this. From the minutes, "It was noted that such an extension might be particularly effective if done in conjunction with a statement indicating that a highly accommodative stance of monetary policy was likely to be maintained even as the recovery progressed."

At one level, this might just seem redundant. After all, the Fed's projections already tell us that rates will stay where they are until late 2014 even though the recovery will be progressing prior to then. But the language might tell investors that the Fed will tolerate a stronger economy than the one in the projections before it raises rates. In some respects this language, depending on how it's written specifically, could accomplish some of the benefits of nominal GDP targeting. That is, the Fed could signal a willingness to accept somewhat higher inflation if the economy is still well below potential.

In short, the Fed seems to think the change in wording will carry some significance, so we'll pay close attention to it.

Any chance the IOER (interest on excess reserves) rate will be cut?

Fed officials have downplayed the notion, but we wouldn't rule it out. The ECB has gone to a zero deposit rate, and money market funds have coped with it, so the Fed could lower the rate. It could shave some basis points off the short end of the curve with such a move. This seems to be below 50% but not off the table.

- Tom Gallagher

Policy & Central Bank Calendar

Highlights for the Week

Heads of state, central bankers, a German court, and Eurozone finance ministers will generate actionable headlines in a busy policy calendar. The return of Congress from a five-week break is most notable for the lack of significant activity expected from the U.S. legislature this month. China's Wen on Tuesday is set to keynote a World Economic Forum speech on his country's forward-looking economy. Germany's constitutional court rules Wednesday on the ESM (Merkel addresses her country's skilled trades organization the next day). The FOMC on Thursday and the Eurogroup on Friday will close a week in which investors gauge policymakers' follow-through in boosting transatlantic economic growth.

Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher | Kevin Nealer | Joel Shin | Eric Melby | Todd Mariano
policy@renmac.com

Monday

- 4am EDT, the Economic Consultative Committee of the BIS stated support for FSA's investigation of LIBOR reforms

Tuesday

- 5am EDT, Wen addresses the World Economic Forum in Tianjin, China
- Noon, ECB's Asmussen discusses central bankers' jobs at the House of Finance in Frankfurt

This Week's Central Bank Meetings

Monday, September 10th

Sri Lanka

- Current repurchase rate: 7.75% (-1.75% real rate)
- Last policy change: 4/5/2012 (25bps)

Wednesday, September 12th

South Korea

- Current repurchase rate: 3.00% (1.80% real rate)
- Last policy change: 7/13/2012 (-25bps)

New Zealand

- Current cash rate: 2.50% (1.50% real rate)
- Last policy change: 3/10/2011 (-50bps)

Thursday, September 13th

United States

- Current fed funds rate: 0.00-0.25% (n/a real rate)
- Last policy change: 06/20/2012 Operation Twist extended
01/25/2012 Rates on hold through 2014

Russia

- Current refinancing rate: 8.00% (2.10% real rate)
- Last policy change: 12/27/2011 (-25bps)

Indonesia

- Current reference rate: 5.75% (1.17% real rate)
- Last policy change: 2/9/2012 (-25bps)

Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher | Kevin Nealer | Joel Shin | Eric Melby | Todd Mariano
policy@renmac.com

Switzerland

- Current target rate: 0.00-0.25% (0.50% real rate)
- Last policy change: 8/3/2011 (-25bps)

Chile

- Current overnight rate: 5.00% (2.50% real rate)
- Last policy change: 1/12/2012 (-25bps)

Philippines

- Current overnight rate: 3.75% (-0.05% real rate)
- Last policy change: 7/27/2012 (-25bps)

Latvia

- Current refinance rate: 3.00% (1.30% real rate)
- Last policy change: 7/13/2012 (-50bps)

Last Week's Central Bank Meetings (Summary)

Country/Region	Key Rate	Other Actions
Russia	Unchanged at 8.00%	
Mauritius	Unchanged at 4.90%	
Australia	Unchanged at 3.50%	
Canada	Unchanged at 1.00%	
Poland	Unchanged at 4.75%	
Thailand	Unchanged at 3.00%	
United Kingdom	Unchanged at 0.50%	
Euro Region	Unchanged at 0.75%	Terminate SMP; launch Outright Monetary Transactions program of sterilized secondary market purchases of sovereign bonds, with EFSF/ESM conditionality.
Serbia	Unchanged at 10.50%	
Sweden	-25bps to 1.25%	
Malaysia	Unchanged at 3.00%	
Egypt	Unchanged at 9.25%	
Peru	Unchanged at 4.25%	
Mexico	Unchanged at 4.50%	

Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher | Kevin Nealer | Joel Shin | Eric Melby | Todd Mariano
policy@renmac.com

LEGAL DISCLAIMER

Renaissance Macro Research, LLC has entered into a partnership for the distribution of the Macro Policy Report. The Scowcroft Group is paid on a contractual basis. The analyst(s) principally responsible for the preparation of this research report certify that the views expressed in this research report accurately reflect his/her (their) personal views about the subject security (ies) or issuer(s) and that his/her (their) compensation was not, is not, or will not be directly or indirectly related to the specific recommendations or views contained in this research report, as such please read the following disclosures carefully.

Renaissance Macro Research/Rafferty Capital Markets, LLC pays various outside sources for research material regarding investments and securities that such outside sources distribute to their own customers. Renaissance Macro Research/ Rafferty Capital Markets, LLC makes the research material available to its clients. Any recommendation, opinion or advice regarding securities or markets contained in such material does not reflect the views of Renaissance Macro Research/ Rafferty Capital Markets, LLC and Renaissance Macro Research/ Rafferty Capital Markets, LLC does not verify any information included in such material. Renaissance Macro Research/ Rafferty Capital Markets, LLC assumes no responsibility for any fact, recommendation, opinion or advice contained in any such research material and expressly disclaims any responsibility for any decisions or for the suitability of any security or transaction based on it.

Specifically, any decisions you may make to buy, sell or hold a security based on such research will be entirely your own and not in any way deemed to be endorsed or influenced by or attributed to Renaissance Macro Research/ Rafferty Capital Markets, LLC. It is understood that, without exception, any order based on such research that is placed with Renaissance Macro Research/ Rafferty Capital Markets, LLC for execution is and will be treated as an unrecommended and unsolicited order. Further, Renaissance Macro Research/ Rafferty Capital Markets, LLC assumes no responsibility for the accuracy, completeness or timeliness of any such research or for updating such research, which is subject to change without notice at any time Renaissance Macro Research/ Rafferty Capital Markets, LLC does not provide investment, tax or legal advice. Under no circumstance is the information contained within such third party research to be used or considered as an offer to sell or a solicitation of an offer to buy any particular investment/security.

Rafferty Capital Markets, LLC., Member SIPC, FINRA, (the "Firm") does not perform or seek to perform investment-banking services for these companies in the future. Analysts receive no direct compensation in connection with the firm's investment banking business. All Rafferty Capital Markets, LLC employees, including the analyst(s) responsible for preparing this research report, may be eligible to receive non-product or service specific monetary bonus compensation that is based upon various factors, including total revenues of Rafferty Capital Markets, LLC and its affiliates as well as a portion of the proceeds from a broad pool of investment vehicles consisting of components of the compensation generated by directors, analysts or employees and may effect transactions in and have long or short positions in the securities (options or warrants with respect thereto) mentioned herein.

Although the statements of fact in this report have been obtained from and are based upon recognized statistical services, issuer reports or communications, or other sources that the firm believes to be reliable, we cannot guarantee their accuracy.

All opinions and estimates included constitute the analyst's judgment as of the date of this report and are subject to change without notice. The firm may effect transactions as agent in the securities mentioned herein.

This report is offered for information purposes only, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such would be prohibited.

Additional information available upon request.

Kim Wallace
kwallace@renmac.com
(202) 470-1518

Tom Gallagher | Kevin Nealer | Joel Shin | Eric Melby | Todd Mariano
policy@renmac.com