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What's next for the Fed?

It may be time to do the Twist.

Despite unprecedented accommodation by the Federal Reserve, the economic environment continues to languish. The pressure on the central bank to do something is intense and there seems to be growing dissension in the FOMC about the next steps. To deal with this dilemma, the Fed has decided to extend their next meeting to two days (Sept. 20 – 21).

Can the Fed do more, or have they run out of bullets?

- The Federal Reserve still has several options, but most are either politically unfeasible or have only limited potential for any near-term positive impact on the economy.
- Expanding the balance sheet through additional security purchases (QE3), pegging interest rates, and raising the target inflation rate have been debated as potential next steps, but none are likely and will be tabled at the upcoming meeting unless economic fundamentals deteriorate much further.
- Reducing the interest rates paid on bank reserves has minimal drawbacks and is a possibility, but the economic impact would likely be minimal.

So, what is the most likely next step?

- Operation Twist may be announced as early as Sept. 21. This would allow the Fed to maintain the current size of their balance sheet, but shift the composition from short/intermediate maturities to longer duration securities.
- The idea would be to sell short duration bonds or let them mature and replace with purchases of longer dated bonds – probably 10 to 30 year Treasuries, but potentially MBS or Agencies.
- The objective would be to pull down long-term interest rates to encourage economic activity.

How should bond portfolios be positioned?

- Although rates could fall further through this process, with yields already low the risk/return to that approach is not attractive.
- Instead, our strategy has been to posture portfolios with duration near the benchmark, but positioned to take advantage of a flattening yield curve. This favors a barbell portfolio strategy.



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