# Observation Deck

## What is 'QE' Anyway?

Paula Solanes, *Portfolio Manager*

As the first quarter of 2012 comes to an end, it is encouraging to review the noteworthy economic data of the quarter and discuss the Fed's posturing. In an effort to fulfill its dual mandate of maximum employment and stable prices, the Fed has focused the last four years on promoting accommodative policy. The hope is to spur growth and fuel the economy in an effort to replenish the 8.8M jobs lost during the financial crisis. Inflation at this point remains benign and sits on the back burner for now. In the meantime, Mr. Bernanke will continue to use his arsenal of monetary tools as inflation remains at bay.

To date, accommodative policy has consisted of various forms of quantitative easing along with the removal of uncertainty on January 25 when Mr. Bernanke announced he was prepared to leave rates unchanged through the end of 2014. This stance resonated with the market that low rates are here to stay for awhile, especially given the weakness of the economic recovery. Quantitative easing has been used many times the last four years. In late 2008 the Fed bought mortgage backed securities In August of 2010 purchases continued and eventually the Fed decided to maintain its balance sheet over $2T (up from about $800B pre-crisis) and continued to purchase securities. In November of 2010 the Fed announced it would buy an additional $600B of Treasury securities through the end of June 2011. The most recent development was the September 2011 announcement of Operation Twist with the plan to sell $400B from the Fed's balance sheet in short-term Treasuries and use the proceeds to buy Treasuries in the longer end, thereby driving long-term interest rates down.

Quantitative easing, at its most basic level, is used around the globe by central banks to spur growth and combat deflation. In addition to the Fed, seven notable central banks are currently engaged in quantitative easing: the European Central Bank, the Bank of Japan, the People's Bank of China, the Bank of England, the Swiss National Bank, Banque de France and Bundesbank.

With all the liquidity injections, the short end of the yield curve is anchored at a low and most recently with the downward shift of long-term rates there has been a "risk-on" mentality fueling equities. The shift has contributed to the wealth effect recognized by the Fed. The recent spike in equities has served as a mere consolation for the housing recovery, which is yet to be seen. In the meantime, the Fed continues to keep a close watch on the economic data and stand ready with more quantitative easing. The most recent headline this month mentioned that sterilized quantitative easing was still in the arsenal. Similar to Operation Twist, sterilized quantitative easing would not increase the already $2.9T balance sheet. Rather, the Fed would add new liabilities to its balance sheet and offset additions by selling securities.

Only time will tell what the next step of the Fed will be. For now the message is loud and clear as Mr. Bernanke continues to provide transparency to the markets. Until there is continuous and long-term positive economic data, the Fed stands ready to assist.

### Markets

| Treasury Rates | |
|---|---|
| 3-Month | 0.07% |
| 6-Month | 0.13% |
| 1-Year | 0.17% |
| 2-Year | 0.33% |
| 3-Year | 0.50% |
| 5-Year | 1.04% |
| 7-Year | 1.61% |
| 10-Year | 2.21% |

| March Total Returns | |
|---|---|
| ML 3-Month Treasury | 0.01% |
| ML 6-Month Treasury | 0.01% |
| ML 12-Month Treasury | 0.00% |
| S&P 500 | 3.29% |
| Nasdaq | 4.28% |

*Source: Bloomberg, as of 03/30/2012*

## Economic Vista

Minh Trang, *CFA, Portfolio Manager*

The economy continued to show signs of strength in March, particularly with the labor market. Nonfarm payrolls came in above expectations at 227K, the sixth consecutive month north of 100K. Some of the job growth can be attributed to a relatively warm winter, but the trend has been encouraging. The unemployment rate held at 8.3 percent.

There was positive news in Europe as well after the second launch of the LTRO and the debt swap for Greek debentures. The sovereign debt crisis in the euro zone seems to have dissipated somewhat for now, given the numerous liquidity programs European officials have instituted. Both of these observations were noted in the recent FOMC meeting. The Federal Reserve, as expected, held rates steady and offered little change to its comments from the previous meeting.

In addition, investor confidence has certainly driven up equity prices during the last three months. For the first quarter of 2012, the S&P was up almost 12 percent. This has been one of the best starts for stocks in as many years. Lastly, the final revision to GDP QoQ for the fourth quarter of 2011 came in unchanged at 3.0 percent. The hope is that similar growth can be replicated in the coming quarters of this year.

## Credit Vista

Melina Hadiwono, *CFA, Head of Credit Research*

The U.S. banking industry continued to have good performance, albeit in a persistently low interest rate environment with increased regulatory and capital scrutiny. This is an optimistic trend that mirrors the recovery of the U.S. economy.

According to the FDIC's *Quarterly Banking Profile* for the fourth quarter 2011, the aggregate net profit was $26.3B for all institutions, an increase of 23.1 percent compared over Q3 2010, supported by lower loan provisioning. The industry posted average ROA and ROE of 0.76 percent and 6.78 percent, compared to historical quarterly industry medians of 0.99 percent and 11.74 percent respectively. In the back of lower revenues, positively, for fiscal year 2011, net income reached the highest level of $119.5B.

Loss provisions have declined for nine consecutive quarters and encouragingly have been relatively broad-based, where more than half of all institutions reported lower quarterly provisions. Positively, loan balances rose by 1.8 percent which is the third consecutive quarter in which total loan balances have increased and representing the largest quarterly increase since fourth quarter 2007. Over the last six quarters, deposits at FDIC-insured institutions have risen by more than $1T and grew by 1.8 percent as large denomination transaction accounts offer unlimited insurance coverage through end of 2012.

Also noteworthy was the continued decline in the number of "problem" institutions in the quarter from 844 to 813 since the peak in 1Q11; however, these failing institutions were mostly smaller, unrated banks. Going forward, the expected U.S. GDP growth and the interest rate outlook would be important measures to determine bank's performance as loan loss provisioning normalizes further.

## Trading Vista

Hiroshi Ikemoto, *Money Market Trader*

With mostly positive U.S. economic news, especially in the employment sector, investors were confident as the equity markets gained and Treasuries sold off for most of the month. The two-year Treasury note rose to 0.39 percent on March 20, the highest yield since July 2011. As you may recall, it was during the August 2011 FOMC meeting when Bernanke stated that rates would stay low until at least mid-2013. However, Treasuries did rally towards the end of the month as Bernanke gave a speech saying that the growth in employment is not sustainable unless the U.S. economy strengthens further, implying that the current level of accommodations is necessary to meet growth objectives.

Corporate bonds cheapened up a bit as investors moved money toward equities. Though LIBOR remained flat as the second LTRO provided European banks with liquidity, yields on bonds maturing in one year increased by five basis points to 40 basis points for industrial issuers and 55 basis points for financials. Bonds maturing in two years also cheapened as Treasury benchmarks increased in yield. Commercial paper remained flat from the previous month, while agencies widened from plus 5 to plus 10 against similar maturing Treasuries.

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