LGL Partners

LGL Partners Market Update

The US Federal Reserve Outlines QE3

September 13, 2012

Summary

The Federal Reserve held the Fed Funds rate unchanged at 0% to 0.25%, as expected, and announced a new round of monetary stimulus by means of extended bond purchases. In an 11-1 decision, the Federal Open Market Committee (FOMC) committed to purchase an additional $40BN of agency mortgage-backed securities every month, and will continue its program (announced in June, 2012) to extend the average maturity of its holding through the end of the year.

The FOMC determined that while economic activity has expanded at a “moderate pace” in recent months, employment growth has been slow. Household spending has increased—but in a bearish sign—business fixed investment has eased. Long-term inflation expectations have been muted, and they expect it to remain at or under 2%, but the FOMC also noted upward pressure on spot prices in several commodities.

The Fed expects its actions to increase its holdings of longer-term securities by about $85BN/month through the end of 2012. The committee was concerned that “without further policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions.” Forward guidance on their low interest rate policy has been extended to “at least through mid-2015,” mostly as anticipated, and the FOMC left open the option of continuing or adding to the program until “improvement is achieved.” They expect that these actions “should put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.”

In some respects, this is the boldest language from the FOMC since 2008 as they are explicitly tying their policy prescriptions to the state of the real economy, and have vowed to hold an extremely accommodative stance until these measures show sustained traction. Most previous efforts had a more explicit, finite time horizon.

Unlike other interventions, the Fed is concentrating its actions in the mortgage markets, signaling that they see a housing recovery as fundamental to a broader economic rebound.

Market response

Some move from the Fed was expected, and this action was significant. The markets found it compelling.

US stocks rallied by 1.7% and reached their highest level since 2007. The FTSE All-World index climbed by 1%. The USD fell, and the Euro crossed the $1.30 mark. Gold rebounded by 2% to hit $1,768 per ounce, but other commodities—particularly economically sensitive ones—were more measured.

Longer-dated US Treasuries sold off some, with the yield on the 30-year bond rising above 3%. The 10-year Treasury did not move much, and remained around 1.75%.

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