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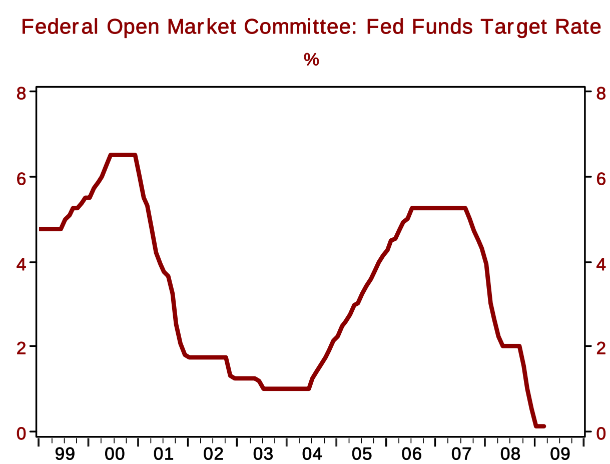
Mar 18, 2009 Economic Commentary

Fed Balance Sheet Explodes

The Federal Reserve today went into overdrive in its attack on the US recession and financial system crisis.

First, the Fed committed to maintaining the target federal funds rate, now in a range between 0% and 0.25%, at exceptionally low levels for "an extended period." At the last meeting in late January the Fed used weaker language, saying rates would stay low for "some time." The change in language reinforces the market consensus that it is highly unlikely the Fed will increase interest rates anytime this year. The first rate increase may not be until March 2010 or later.



Second, to support the housing market, the Fed greatly expanded its potential purchases of mortgage-backed securities issued by Fannie Mae and Freddie Mac, from $500 billion to $1.25 trillion. The Fed also doubled to $200 billion its potential purchases of Fannie/Freddie debt.

Third, the Fed said it will expand the TALF (Term Asset-Backed Securities Loan Facility) – a recently-launched mechanism to ease credit for consumers and small businesses – by expanding the range of eligible collateral it will accept. This sounds like it will soon start accepting securities that get lower ratings.

Last, and perhaps most significantly, the Fed committed to purchasing up to $300 billion in long-term US Treasury securities over the next six months. Such a policy move had been hotly debated at the Fed for the last several months, resulting in one public dissent at the meeting in January from the decision not to start the purchases at that time. By contrast, today's decision by the Fed was unanimous.

The financial markets reacted violently to the Fed's announcement: with stocks rising, Treasury prices soaring, gold spiking upward, and the dollar falling against other major currencies. The yield on the 10-year Treasury note, which had closed at 3.00% on Tuesday, closed at 2.53% today, apparently the largest one-day swing since 1987.

Outside these hugely important policy moves, the Fed's statement made some slight changes regarding its description of the outlook for economic growth and inflation. On economic growth, it deleted a reference from the previous statement saying it expects a recovery to "begin later this year." Perhaps Chairman Bernanke's recent televised comments made this language redundant. The Fed also deleted a reference to significant downside risks to its outlook for growth.

On inflation, the Fed altered its rationale for inflation staying subdued, maintaining a reference to "economic slack" but eliminating a reference to declining prices for energy and other commodities.

Implications

We are definitely fearful of the long-term consequences of massively easy monetary policy, which today's policy statement clearly signals. The US does not face a deflation problem, as February reports on producer and consumer prices revealed. As a result, easy money will become even more problematic than conventional wisdom believes or understands.

Despite the long-run problems with inflation, the US stock market has had a great dose of good news in the past week. Not only are there serious signs of a velocity turnaround underway (see retail sales and housing starts), but mark-to-market accounting reform (good, not perfect) is on the way. And now, the Fed has jumped in with both feet. These three developments should be causing serious indigestion for the short-sellers of US stocks. So, despite some problems developing down the road, like 1975-1976, because of policy today a significant rally in stocks over the next year has become a very probable outcome.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Senior Economist*

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in January indicates that the economy continues to contract. Job losses, declining equity and housing wealth, and tight credit conditions have weighed on consumer sentiment and spending. Weaker sales prospects and difficulties in obtaining credit have led businesses to cut back on inventories and fixed investment. U.S. exports have slumped as a number of major trading partners have also fallen into recession. Although the near-term economic outlook is weak, the Committee anticipates that policy actions to stabilize financial markets and institutions, together with fiscal and monetary stimulus, will contribute to a gradual resumption of sustainable economic growth.

In light of increasing economic slack here and abroad, the Committee expects that inflation will remain subdued. Moreover, the Committee sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term.

In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide greater support to mortgage lending and housing markets, the Committee decided today to increase the size of the Federal Reserve's balance sheet further by purchasing up to an additional $750 billion of agency mortgage-backed securities, bringing its total purchases of these securities to up to $1.25 trillion this year, and to increase its purchases of agency debt this year by up to $100 billion to a total of up to $200 billion. Moreover, to help improve conditions in private credit markets, the Committee decided to purchase up to $300 billion of longer-term Treasury securities over the next six months. The Federal Reserve has launched the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses and anticipates that the range of eligible collateral for this facility is likely to be expanded to include other financial assets. The Committee will continue to carefully monitor the size and composition of the Federal Reserve's balance sheet in light of evolving financial and economic developments.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Charles L. Evans; Donald L. Kohn; Jeffrey M. Lacker; Dennis P. Lockhart; Daniel K. Tarullo; Kevin M. Warsh; and Janet L. Yellen.