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Main Street Matters

"To help support the economic recovery in a context of price stability, the Committee will keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities."

...and with that dry statement from the Federal Open Market Committee on Tuesday, it was made plain that Fed Chairman Ben Bernanke stands ready as ever to hook every American man, woman and child to the economic equivalent of a heart-lung machine till these long hours of massive private sector deleveraging are through.

The significance of this is not in the tool itself – the Fed already bought longer-term Treasuries during the crisis – but rather in what it suggests for the direction of policy. The year began with the Fed discussing how it would begin to shrink its balance sheet and let private market factors resume their natural course; halfway into the year, such measures are hereby shelved.

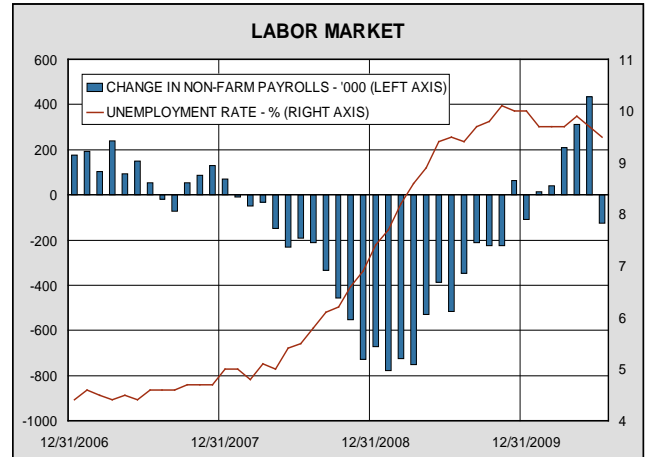
Keep in mind, even before this announcement (and some three quarters since the Fed bought in Treasuries, on net), the 10-year Treasury yield had dropped below 3% and the 30-year below 4%, *despite* policy allocations away from US Treasury debt by foreign central banks earlier this year (China, conspicuously, reallocating to the euro just in time to see that currency crack up; so much for the economic infallibility of the People's Bank).

So it's not as if there's been any plunge in demand for Treasury obligations that needs braking; to the contrary, heaps of new issuance have been met by a voracious domestic appetite for nominal safety. In other words, the private market all by itself was bringing down the long end of the interest rate curve... why should the Fed now use its balance sheet to supplement that abundant demand?

The evident conclusion: The Fed doesn't think 2.8% on the 10-year Treasury and 3.9% on the 30-year are low enough for how sluggish our economic fundamentals remain.

As our main Exhibit supporting the Fed's diagnosis

if not necessarily the remedy it prescribes, we offer the following chart showing how few of the jobs annihilated in 2008-2009 have been restored:



Source: Northern Trust, Bloomberg

The trend has been good insofar as payrolls have grown in 2010 (till lately, at least), but until the volume of new bars above the zero line surpasses those below it, we're still in the hole, employment wise. As you can see, we're not even close to backfilling what's been lost.

If the employment picture constitutes a big, ongoing hit to Main Street's aggregate income statement, the housing picture remains a hole in Main Street's balance sheet (home values still down 29.1% from their peak, as measured by the S&P Case-Shiller 20-city composite). Efforts to backfill *that* hole haven't done the trick, whether the expired homebuyer tax credits, which pulled demand forward temporarily yet at permanent cost to the public weal, or loan modification programs now suffering non-performance rates of 20% after three months and 57% after a year for the most recent vintages reported in Fannie Mae's 2Q 2010 Credit Supplement.

After so many hundreds of billions of taxpayer dollars were shoveled into the smoking crater Lehman's implosion left on Wall Street, are Fed efforts to bring down the further reaches of the yield curve a good measure now for Main Street?

For now, and until the bill comes due via inflation later this decade, the answer is yes for anyone who can refinance or take on a new mortgage – mortgage rates correspond strongly with long Treasury rates, and a reduction in the latter should improve the former. The Fed's Treasury purchases won't, however, fill the holes for everyone else.