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The Return of Quantitative Easing

We have witnessed two key events since our last newsletter that shape both our near term and long term outlook for the economy and interest rate markets – the November election and the Federal Reserve's plan for round two of monetary stimulus. While the Republican takeover of the House and advances in the Senate have captured the media headlines, the story that will likely have a greater impact on the economy and financial markets for the foreseeable future is the one that came out of the Federal Reserve.

A second consideration lies with the fate of the Build America Bond (BAB) program, which, as part of the original stimulus bill, has allowed bond issuers to choose whether to issue their debt in the traditional tax exempt market (which has always enjoyed an indirect subsidy via tax-free income to investors) or the taxable market with a direct federal subsidy to the issuer. The expansion of the BAB program over the past 2 years has meant meaningfully less supply of new bonds in the traditional tax-exempt market,

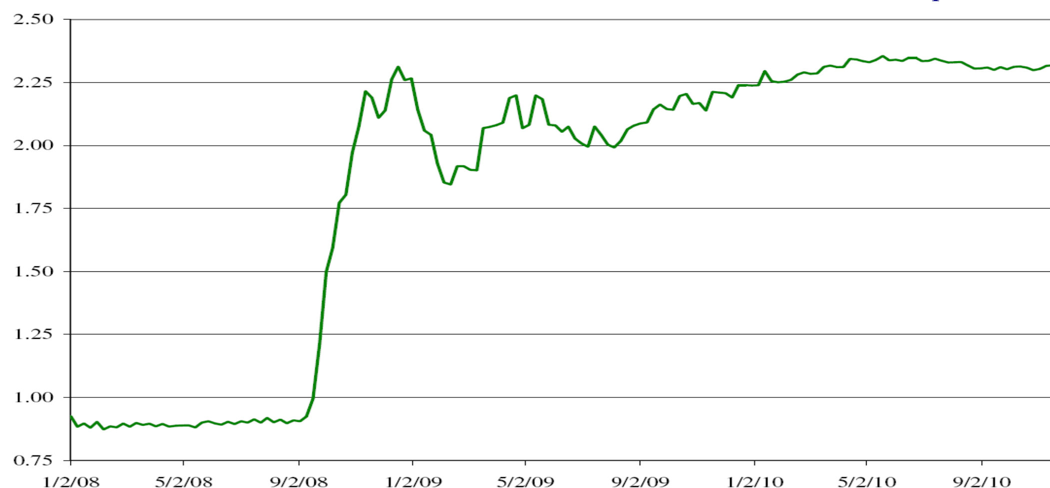

Figure 1. *Growth of the Fed's Balance Sheet (in $trillions) 2008-Present* Source: Bloomberg

which has driven prices higher and interest rates lower. Like the Bush era tax cuts, the BAB program is set to expire on December 31, 2010. The new tone in Washington is not keen on anything that hints of a subsidy, and uncertainty remains (as of this writing) whether or not the program will be extended and if so in what form. If the BAB program expires, 2011 would likely see a meaningful increase in tax-exempt supply, higher tax-exempt interest rates, and lower prices for municipal bonds.

The November election brings likely legislative changes and a new mood in Washington with implications for the municipal bond market. For one, the fate of the Bush era tax cuts that are set to expire on December 31st of this year has evolved from certain expiration to the likelihood that some, if not most, of the tax cuts will be extended. Earlier this year, when expiration seemed a far likelier outcome, tax-exempt bond returns benefited from the expected incremental advantage over taxable alternatives. With that increased advantage less likely, tax-exempt bonds no longer enjoy the benefit of that expectation.

Finally, the new mood in both Washington and across the country seems to suggest

Highlights:

- Fed maintains 0-0.25% Fed Funds rate
- The Fed reveals plan for QE2, begins purchase of longer dated Treasury securities
- Caprin repositioning longest maturities to shorter dated bonds; returning to more laddered structure
- Caprin managing intermediate portfolios to a slightly shorter-than-neutral duration target

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that, as the financial condition at both the state and local level faces continued challenges, troubled municipalities are less likely to receive financial support from the federal government. This elevates the importance of focusing on credits and issuers that are best positioned to endure ongoing budgetary pressures.

While the implications of the election results cannot be ignored, Caprin believes that there are far greater repercussions from the Federal Reserve's decision to implement the second round of Quantitative Easing (QE2). Chairman Bernanke is arguing the case that deflationary and recovery concerns warrant further Fed intervention. The Fed will be deploying up to $600 billion into the financial system through June 2011 by purchasing U.S. Treasuries with intermediate and longer term maturity dates. Detractors fear that the Fed's latest barrage of stimulus may potentially create longer-term inflationary pressures and devalue the U.S. dollar.

For the time being, it seems that inflation is not a near-term threat and that the Fed has room to maneuver as housing and unemployment remain weak. However, the cumulative effect of multiple rounds of fiscal and monetary stimulus has created an environment with significant government-supplied liquidity in the financial system. A weak economy wrestling through the pains of deleveraging has meant that stimulus has largely remained parked on the sidelines. If and when a recovering economy begins to gain any traction, the potential for that liquidity to begin to work its way through the system elevates our concerns over longer term risks of inflation and higher interest rates. The question remains whether the Fed will be able to remove successfully what may prove to be an excess of money as the economic landscape improves.

Caprin Strategy

Over the past year and a half we have taken steps to address longer term concerns. Our strategies have sought to reduce exposure to bonds with short call dates and long final maturities, as these bonds are particularly vulnerable to an increase in interest rates. Earlier this year we employed a slight barbell strategy, lowering exposure to maturity windows that may see larger price reductions in the event of rising interest rates and a flattening yield curve. We have also strived to maintain high credit quality as state and local governments continue to struggle with budgetary shortfalls. While we implemented these strategies, we maintained a neutral duration target, keeping accounts invested in the market as our short term outlook for a weak recovery and low interest rates remained relatively in tact.

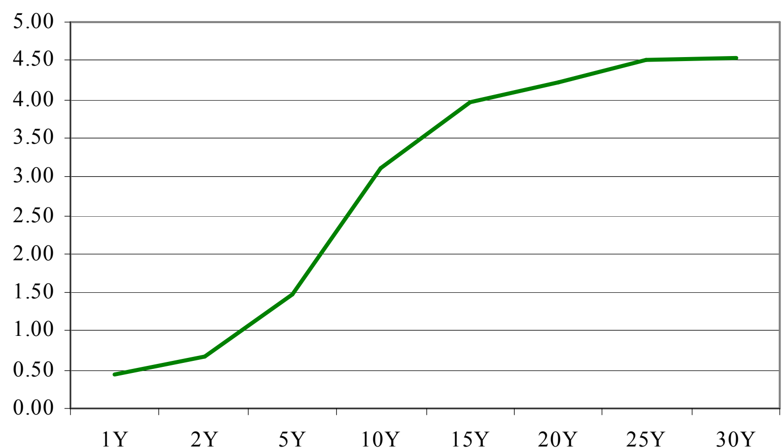

***Figure 2**. U.S. Muni G.O. AAA Yields as of 11/29/10* Source: Bloomberg

However, with the emergence of QE2, a potentially less-accommodative federal government, and a low absolute interest rate environment, we believe that the balance of risks has shifted and warrants a more cautious approach. While the timing of the next interest rate cycle remains difficult to predict and we remain loathe to "fight the Fed" in the near term, Caprin will be looking to position accounts defensively early rather than late. Therefore, our portfolios will be allowed to drift towards a shorter duration target over the next several months. We will also be looking to reposition some of our longest maturities and return to a more laddered curve structure, as the uncertainty surrounding the BAB program may add to volatility. We will continue to focus on credit and liquidity, with an emphasis on staying nimble as policymakers, investors, and consumers shape the fundamentals driving the Municipal landscape.

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