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Fed Ready and Willing to Restart Quantitative Easing

The National Bureau of Economic Research concluded on September 19th that the 18-month long "Great Recession" drew to a close in June 2009, yet the ensuing time period would hardly fit the definition of a "Recovery". The length, scope, and severity of the 2008-2009 crisis make this (virtually unanimously) the worst economic downturn since the Great Depression. While short-term measures including stimulus dollars, tax credits, and inventory rebuilding may have provided the support needed to stem the recession, these efforts do not appear to have generated a sustainable, demand-based economic recovery. Recent broad-based weakening of data suggests, and the Fed apparently agrees, that the official end of the last recession by no means signaled the beginning of the next boom. With the growth and recovery outlook deteriorating, the Fed appears to have a much heightened awareness of deflation driven by the general contraction of credit and the lack of final demand. As such, the Federal Open Market Committee once again left the Fed Funds Rate unchanged (0-0.25%) on September 21st in an attempt to encourage economic activity. However, a low Funds rate will not be enough. The primary means of stimulating growth in the current environment is the money supply and the Fed has surfaced the possibility of yet another round of Quantitative Easing (QE2) that will add reserves (i.e. money supply) into the banking system However, there is a downside to too much QE: inflation.

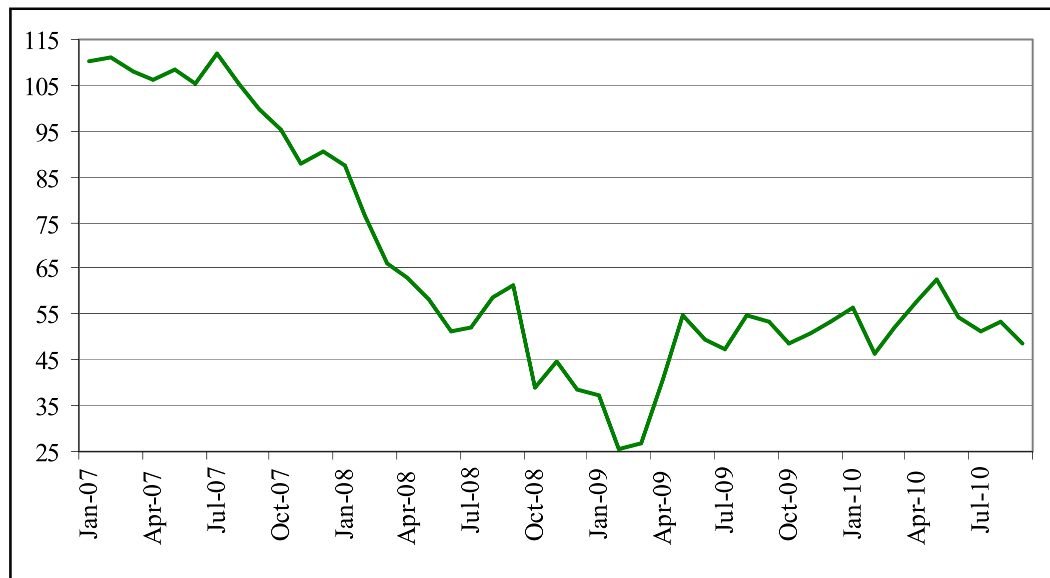

Figure 1. *Consumer Confidence Index levels from January 2007-September 2010* Source: Bloomberg

The headwinds of a high unemployment rate and depressed home prices continue to weigh heavily on recovery and pose unique challenges to state and local governments. Income tax revenues are impacted by fewer workers earning lower wages. Sales tax revenues are depressed by pessimistic

Highlights:

- Fed maintains 0-0.25% Fed Funds rate
- The Fed could restart purchasing gov't debt to help expand the money supply; i.e. Quantitative Easing 2
- Caprin building portfolios with a slight "barbell" structure, emphasizing longer and shorter maturities
- We continue to manage to a neutral target duration of 5.0 years

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consumers spending less income, and property tax income is affected by falling assessments and significantly fewer real estate transactions. On the expense side, unemployed citizens generally require increased support from their local and state governments via unemployment insurance, food stamps and other social services. Federal aid has helped plug the gap, but cuts in state and local government workforces have only exacerbated the unemployment stress.

As stated in previous newsletters, we view the risk of widespread municipal defaults as "exaggerated." However, state and local governments face an uphill climb in the march towards fiscal health. In this environment, Caprin remains focused on maintaining high-quality portfolios complemented by the ongoing surveillance of opportunities and holdings in this evolving credit landscape.

Caprin Strategy

With the Fed determined to keep interest rates low in the fight against economic weakness, the table is set for the current low interest rate environment to persist for the short term. However, the massive liquidity provided by the Fed and the Treasury via a QE2 would likely lead to inflation and higher rates down the road. We are loathe to fight the short term momentum driven by the Fed, but at the same time we remain wary of longer term pressures. Accordingly, Caprin remains neutral in managing interest rate risk via a 5.0 year duration target.

We are currently investing lightly in the first year of the yield curve to prevent a large number of maturities in the next 6-12 months when we expect rates to still be historically low. If yields begin to rise, Caprin will reposition portfolios accordingly to take advantage of more attractive returns in the front end of the curve. Taxable Build America Bonds (federally subsidized bonds that provide beneficial tax credits to the issuer) are still prevalent in longer maturities and continue to limit the amount of traditional tax-exempt supply with maturities of 15 years and longer. We still see value in owning the traditional tax-exempt munis in this area while the high demand/low supply engine is at work. Therefore, we continue to buy slightly heavier weightings in these longer maturities while counterbalancing the increased volatility with more 1 to 3 year maturity bonds.

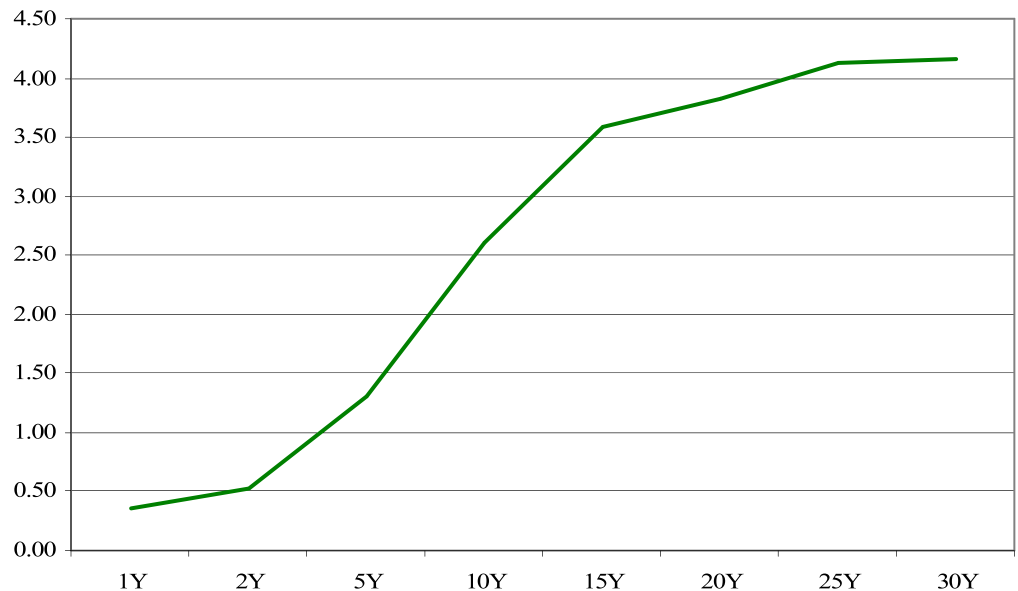

Figure 2. *U.S. Muni G.O. AAA Yields as of 10/08/10* Source: Bloomberg

Our strategies continue to emphasize high-quality, liquid portfolios in order to remain nimble in the current environment. The slow pace of the recovery and likely bumps in the road suggest ongoing market volatility. Caprin strives to maintain our disciplined approach to managing credit and interest rate risk as we navigate through this period of economic rehabilitation.

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