The Federal Reserve’s (Fed’s) policymaking arm, the Federal Open Market Committee (FOMC) highlights this week’s relative busy mid-month economic and policy calendar. We take a closer look at Fed policy in this week’s publication. Elsewhere, after larger-than-expected rate cuts last week by central banks in Brazil and India, rate setting meetings are scheduled this week in Mexico, Norway, Switzerland and Japan. This week’s economic calendar includes U.S. reports on manufacturing (Philly Fed and Empire State) for March, industrial production in February, and consumer and producer prices in February. Rising gasoline prices will grab the headlines in these reports. Markets will continue to digest last week’s economic reports for February in China, as well as a full docket of European economic reports for January and February. Japan will likely be in the news this week as the one-year anniversary of the earthquake, tsunami and nuclear disaster is recalled. There are several bond auctions in Europe this week, and European finance ministers will meet to discuss the €14.5 bond maturity Greece faces on March 20.

Will the Next Round of QE Be “Sterilized?”

Operation Twist—an effort by the Federal Reserve (Fed) to keep 10-year Treasury yields low by selling its short-term Treasury holdings and purchasing longer-term Treasuries in the open market—is set to end at the end of June 2012. Markets are now sizing up the likelihood of another round of monetary stimulus from the Fed, following quantitative easing 1 (QE1) (2008–2010), QE2 (2010–2011), and Operation Twist (2011–2012). Quantitative easing refers to large-scale bond purchases, consisting of Treasury or agency mortgage-backed securities (or both) by the Fed in the open market.

Our view is that another round of stimulus from the Fed, in whatever form it takes, is data dependent. We also think political hurdles—both inside the Fed and among the Fed’s bosses in Congress—have been the largest impediment to another dose of quantitative easing. Events last week (March 5–9) suggest that the Fed may have found a way to lower those political hurdles a bit.

In short, if we see robust economic growth (3–4%) between now and the end of June 2012, we would expect the Fed to hold off on another round of quantitative easing (QE). But the current pace of growth (2%) or slower growth would likely lead to another dose of stimulus.

Federal Reserve officials hinted in a well-placed and well-timed Wall Street Journal article last week that the next round of QE would be “sterilized.” This...
means that the Fed would immediately borrow back some of the cash it injects into the financial system as it purchases the securities in the open market. The Fed hopes to address one of the main political hurdles to another round of QE: the long-held fear that more monetary stimulus would trigger a surge in commodity prices and inflation. (We note that the WSJ article was published just a week before the upcoming March 13 Federal Open Market Committee [FOMC] meeting).

Politics Plays an Even Bigger Role in Policy in a Presidential Election Year

For many in the political class in Washington (and for the public at large), sterilized QE would not be regarded as inflationary, and the Fed would face less of a public relations battle should it decide to pursue that course of action. Of course, politics is nearly unavoidable in Washington, DC in any year. But in a presidential election year, politics often plays an even bigger role in policy—even when it comes to the Fed, which has been viewed in recent years (last 30) as a nonpolitical and independent organization.

For the record, the Fed has either raised or lowered (and in some cases both in the same year!) its short-term policy rate in every single presidential election year starting in 1968. In general, the Fed wants to avoid mingling in politics during an election year, and it may prefer to hold off on changing rates in the months just prior to the election in November. But when push came to shove over the past 40-plus years, the Fed acted to change policy as conditions warranted and is likely to do so again this year if conditions warrant.

Breaking Down the Fed’s Menu of Options

The Fed has two more FOMC meetings (this Tuesday, March 13 and the two-day meeting at the end of April) to discuss another round of stimulus before Operation Twist ends at the end of June. As it is only a one-day meeting, a decision is unlikely to be made at this week’s FOMC meeting. But if history is any guide a full discussion of the full range of options open to the Fed is likely at this week’s meeting. The market will get a scrubbed version of the minutes of this week’s FOMC meeting in three weeks’ time, on April 3.

As it stands now: 1) doing nothing; 2) extending Operation Twist or embarking on QE3, but sterilizing the purchases; 3) or doing a non-sterilized version of QE3 seem to be on the menu of options. Last week’s WSJ article suggests that if the Fed does decide that the economy needs more QE, it will likely pursue sterilized QE.

By allowing Operation Twist to expire at the end of June, the Fed would probably be signaling that it is comfortable with a steady climb higher in longer dated Treasury yields, which in turn would push borrowing rates for consumers and businesses higher. We have noted in other LPL Financial Research publications like Bond Market Perspectives that Operation Twist has been quite successful. We have highlighted that it is one of the key reasons why the 10-year note yield has remained near 2% in the past six months, despite less volatility in Europe, firmer U.S. economic activity and sizable gains in the U.S. equity markets.
Extending Operation Twist would help to keep the 10-year note yield (and likely consumer and business loan rates) lower than otherwise. However, there are some technical impediments, as the Fed (and Treasury) is running low on short dated debt to sell in order to fund purchases of longer dated Treasuries.

That leaves QE3 sterilized and QE3 non-sterilized as options. In either case, the Fed has hinted in recent months that the mortgage market would be a bigger target for QE3 than it was in QE2 (no MBS purchases) or in QE1 when the Fed bought both MBS and Treasuries in the open market.

**Risks and Rewards of QE3 Are Being Carefully Considered**

Questions remain (inside and outside the Fed) about the efficacy of doing another round of QE. Fed Chairman Ben Bernanke has made it clear that the FOMC carefully weighs the risk against the benefits of doing more QE. The risk/reward trade-off may be even less clear-cut when weighing sterilized QE3. Past examples of sterilized QE (Japan or Europe) have had mixed results at best. The Fed borrowing to buy safe assets from the private sector encourages private investors to take on more risk (which could potentially help the economy). The degree of market impact is potentially greater than with Operation Twist. Unlike with Operation Twist, sterilized QE doesn’t change the mix of assets already on the Fed’s balance sheet. It adds the new assets the Fed is purchasing, and the borrowing to fund those purchases gets added as liabilities. So the impact on the assets is the same as in an unsterilized QE.

Will the Fed do it? We believe the odds strongly favor a sterilized QE. A few months of weaker economic data would get the Fed there, since the economy will likely come in below Fed expectations (FOMC sees 2.5% GDP this year and 3.0% next year), and making it “sterilized” eases a political hurdle about future inflationary consequences. With oil prices high and economic data softening around the world, a modest dip in the data could prompt action.

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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<tr>
<td>Perception among public and Congress is that sterilized intervention does not cause inflation</td>
<td>May further push up short-term rates</td>
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<tr>
<td>Lowers political hurdles for QE3 if necessary</td>
<td>Uses a tool designed for its exit strategy (i.e., reverse repos or withdrawing cash from the system instead of injecting cash) to further ease policy</td>
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<tr>
<td>Keeps Treasury and MBS rates lower, which continues to encourage more consumer and business borrowing</td>
<td>Benefits of the purchases could be outweighed by the exit strategy</td>
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<td>Pushes certain pools of investors further out on the risk spectrum</td>
<td>Hurts borrowers due to higher short rates</td>
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<tr>
<td>Extends the QE counterparties beyond primary dealers to money market mutual funds, commercial banks, and may improve functioning of money markets</td>
<td>Does not push up commodity stocks the same way QE1 and QE2 did</td>
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<tr>
<td>Does not expand Fed’s balance sheet; just changes composition</td>
<td>Begs the question: Why didn’t the Fed sterilize QE1 and QE2?</td>
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<td>Helps savers by pushing up short-term rates</td>
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<tr>
<td>Better than doing nothing when Operation Twist ends</td>
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<tr>
<td>Not likely to push up global commodity prices</td>
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Source: LPL Financial

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**LPL Financial Research 2012 Forecasts**

- GDP 2%*
- v
- Private Payrolls +200K/mo.

Please see our 2012 Outlook for more details on LPL Financial Research forecasts.

**IMPORTANT DISCLOSURES**

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

* Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Federal Funds Rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

Private Sector – the total nonfarm payroll accounts for approximately 80% of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly, on the first Friday of the month, and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity. It doesn’t include:
- general government employees
- private household employees
- employees of nonprofit organizations that provide assistance to individuals
- farm employees

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation’s open market operations (i.e., the Fed’s buying and selling of United States Treasury securities).

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.

London Interbank Offered Rate (LIBOR): An interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers’ Association. The LIBOR is derived from a filtered average of the world’s most creditworthy banks’ interbank deposit rates for larger loans with maturities between overnight and one full year.