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Your guide to understanding today's economy and financial markets

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This Way to the Exit

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The Federal Reserve's modest increase in its largely symbolic discount rate on February 18 was perhaps the most visible sign yet that its "exit strategy" is well underway. More moves to the exit will be undertaken in coming weeks and months, including the previously announced cessation in late March of its mammoth purchase of mortgage-backed securities.

Note: the Fed DID NOT change its much more important federal funds rate, which has been fixed in a target range of 0.00%-0.25% for the past 14 months. In fact, the Fed reaffirmed again that this rate will remain unchanged for an "extended period."

The Fed has been actively engaged in numerous economic and financial market life support programs since global financial markets froze up the first time in August 2007. Such programs became more frequent as the U.S. and global economies faced nearly unprecedented challenges during the final few months of 2008.

These imaginative and largely necessary programs all fell under the banner of "quantitative easing" and involved the Fed more than doubling the size of its balance sheet from roughly $800 billion to more than $2 trillion…all with newly created money.

A return of both U.S. and global economic growth in recent quarters has provided the Fed an opportunity to begin the process of reining in some of the massive monetary stimulus that provided support to the U.S. economy during the Great Recession…the longest, most painful, most costly, and most pervasive since the Great Depression. Most forecasting economists suggest the recession ended sometime between June and September 2009.

Rate Change

The Fed increased the discount rate, the rate at which commercial banks obtain "emergency" loans from the Fed, from 0.50% to 0.75%. Another similar increase or two is likely in coming months. The discount rate had typically been 1.00% or so above the federal funds rate under more normal circumstances. Such loans have averaged less than $15 billion weekly in recent weeks, a minor hiccup in a world of trillion dollar annual budget deficits.

In tandem with the rate change, the Fed noted that the move doesn't "signal any change in the outlook for the economy or monetary policy" and is "not expected to lead to tighter financial conditions for households or businesses." It does perhaps make it somewhat more likely that the Fed will increase the federal funds rate during latter 2010.

Fed Chair Ben Bernanke

Balance

The Fed faces an extremely delicate balancing act during the next 24 months. It must withdraw excess monetary stimulus so as to not allow inflation pressures to become solidly entrenched in the economy. At the same time, the Fed must continue to provide enough monetary stimulus to help the fragile economic recovery establish deeper roots…

…not a job for the faint-hearted

The Fed will face enormous pressure from the Congress over the next 24 months to limit steps to rein in prior stimulus. Various Congressional members will call for the Chairman's head as he tightens monetary policy while the unemployment rate is still unacceptably high. Note: Congressional criticism of the Fed is rarely in short supply as the Fed is always a convenient scapegoat for Congressional shortcomings.

Mortgage Rates?

Of concern in the housing and mortgage finance sector is the direction later

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this year of 30-year fixed-rate mortgages for conventional loans. One factor that has led to stabilizing home values and increased buyer interest has been some of the lowest mortgage rates in nearly 40 years.

Fed Forecast for 2010

The Federal Reserve updated its forecast last week of key economic measures for 2010. Below are the latest forecast figures, compared to the forecast figures from November 2009:

	November 2009	February 2010
Economic growth (GDP)	2.5% to 3.5%	2.8% to 3.5%
Unemployment rate*	9.3% to 9.7%	9.5% to 9.7%
Inflation	1.0% to 1.5%	1.1% to 1.7%

*At year-end 2010; Source: USA TODAY

Perhaps the primary reason these long-term interest rates have been at or slightly below 5.00% in recent weeks has been the enormous amount of buying of mortgage-backed securities by the Federal Reserve. The Fed's leadership decided last year that helping to push long-term mortgage rates lower was perhaps the easiest way to help stabilize housing markets across the U.S.

Their tool of choice was a program to purchase more than $1,400,000,000,000 of mortgage-backed securities and U.S. Treasury debt. By some estimates, the Fed bought as much as 80% of the mortgage-backed securities issued during the past year or so.

What happens when this enormous vacuum sucking up massive amounts of mortgage securities is turned off? What happens when the Fed decides to begin methodically selling such securities back into financial markets in order to shrink the size of their bloated balance sheet?…

…$64 questions both

Fed Chairman Bernanke tried to allay such fears in recent days, suggesting that the Fed will hold many securities for a substantial time to come. He also suggested that any selling program would not commence until the Fed had begun to push its key short-term interest rate, the federal funds rate, higher.

In any event, "supply and demand" does work sometimes. A massive decline in the demand for mortgage-backed securities leads most market players and prognosticators to expect mortgage interest rates to be somewhat higher later this year and in 2011…

…NOW remains an attractive time to refinance a mortgage or finance a new purchase (if one is able to do so)

Confidence Plunges

One factor clouding the U.S. economic outlook is weak confidence levels of consumers. The Conference Board reported on February 23 that its consumer confidence index came in much weaker than expected.

The primary culprit? A lack of jobs.

The Index, which measured 56.5 in January, plunged to 46.0 in February, sharply below expectations, and the lowest level since April 2009. The index is based on a survey of 5,000 American households and is meaningful since consumer spending represents nearly 70% of the American economy.

The two-part index is comprised of a "present situation" component as well as an "expectation" component. The present situation measure actually hit a 27-year low of 19.4, suggesting consumers are actually less confident than at the heyday (or is it lowday?) of the financial crisis in late 2008.

The expectation component fell to 63.8 from 77.3 in January. Consumers are no doubt reflecting pessimism about the availability of jobs today or in coming months. The frustrating nature of childish political behavior in Washington DC by both parties, combined with rising anxiety about government spending out of control, is also no doubt adding to consumer anxiety.

Jeff

"TEA"ser

If a parsley farmer is sued, can they garnish his wages?

—from Sharron Horsey

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