

## Reaction to the Federal Reserve's latest move

September 21, 2011

The Federal Open Market Committee announced that it is going to “extend the average maturity of its holdings.” In layman’s terms, that means it is going to sell \$400 billion of its shorter-term notes (those with remaining maturities of three years or less) and buy \$400 billion of longer-term notes (those with remaining maturities of six to 30 years)..

The committee noted the dangers the U.S. economy, evermore tied to the global economy, continues to face. It left short-term rates at 0 percent-0.25 percent (and reinforced that those rates likely won’t move before mid-2013).

The Fed further said it was reinvesting a greater percentage of its principal payments in agency mortgage-backed securities. Buying longer notes and investing more in the agency mortgage-backed securities is designed to support a still-struggling housing market by allowing homeowners to refinance at lower rates.

But it’s a plan that simply won’t work, said **James Camp, CFA, head of Eagle’s Fixed Income team.**

“The Fed has moved money on its balance sheet but there are still many structural impediments in place that will prevent this from doing what the Fed wants it do,” said Camp, who added the Fed’s move was mostly expected and already priced into the market.

The fact is that 30 percent of homes are under water, said Camp. Those people cannot refinance no matter where the Fed sets interest rates. Banks have tightened lending restrictions to pre-real-estate-bubble levels and those who are able to refinance likely already have. So, it’s not likely that a significant number of homeowners will be able to refinance or that new buyers will be able to enter the market.

It’s not clear the Fed’s move will help consumers but it most definitely will hurt already struggling money-center banks, said **John Pandt, CFA, a co-manager of Eagle’s Equity Income and Value programs.** The traditional bank money-making model has been to borrow on the short end of the interest-rate yield curve and loan at the long end; consequently, lowering the longer-term rates eats into the banks’ already-thin margins.

Further, there are certain limits to how low mortgage rates realistically can go, said Pandt.

As always, prudent investors want to ensure they are being compensated adequately for the amount of risk they presume they are taking. Driving potential yields down on mortgage-backed securities at some point simply prompts investors to walk away. It simply doesn’t behoove banks to make mortgage loans if investors won’t buy them.

Additionally, the banks remain paralyzed generally as they await a final decision from the federal government about how much capital they need to keep on their books, said **Ed Cowart, CFA, also a co-manager of Eagle’s Equity Income and Value programs.** Many have significant amounts of cash currently but they are afraid to let it go until they can be sure that they will be considered adequately funded.

The real problem – and one that isn’t going to be fixed by the Fed’s move – is that there simply is too much debt: here and abroad, said **Todd McCallister, CFA, head of Eagle’s Small/Mid Cap Core programs.** The Federal Reserve already has rates at 0 percent; there is little else it realistically can do to stimulate an economy awash in debt.

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None of the managers indicated the Fed's move would change their investment approach.

"We had anticipated this and slightly extended the duration of portfolios in anticipation of the Fed's move today," said Camp.

Similarly, the Equity Income team already was on alert to those banks it deemed particularly interest-rate-sensitive, said Pandle. For instance, it sold Bank of Nova Scotia in August. Relative to the other major Canadian banks, Scotia is more exposed to potential economic and sovereign weakness in developed and emerging markets with approximately 55 percent and 45 percent of its earnings generated outside of Canada and North America, respectively.

The Fed's announcement underlined the idea that the U.S. economy likely will continue on a low-growth trajectory for some time, said McCallister.

That isn't all bad news.

It is in those environments when investors typically want to invest in those companies they believe are priced to reflect realistic growth rates: the types of companies that McCallister likes to buy for his portfolios (and those the market has ignored over the last couple of years).

And pushing down interest rates all along the yield curve should make dividend-paying investment strategies (e.g., Equity Income) all the more appealing to those seeking income, especially tax-advantaged income, said Pandle.