

Flash Comment

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FOMC: The sound of whirring rotors

Overview: The Federal Reserve and the Treasury this afternoon announced new measures to secure the flow of credit to the economy to prevent a deepening of the slowdown. Specifically, the measures are targeted to support the mortgage market and the market for securities backed by credit card, auto, student and small business loans, and should help to bring funding costs lower. With today's announcement the **Federal Reserve has now moved to full scale quantitative easing**. The central bank will now be expanding its balance sheet further, printing money to buy longer term debt in the market.

Market reaction: Following the announcement, the swap and agency spreads narrowed significantly. Agency spreads narrowed mostly in the long end. In the treasury curve, 2-year bond yields remain roughly untouched, as the expected path for fed funds rate was left unchanged. The long end of the Treasury curve moved lower with 10-year bond yields losing 10-15 bps. Generally, the move should be positive for risky assets. The equity market reacted cautiously positive, with S&P500 futures jumping on the announcement.

Details: The new initiatives include a program in which the Fed will buy as much as USD 600bn of mortgage debt corresponding to approximately 5% of the outstanding amount of mortgage credit. The central bank is authorised to buy up to USD 500bn of mortgage backed securities (MBS) backed by Fannie Mae, Freddie Mac and Ginnie Mae. The remaining USD 100bn will be bought directly from the GSEs and Federal Home Loan Banks in competitive auctions beginning from next week. In contrast to the standing lending and swap facilities for MBS, the Federal Reserve is now taking the entire credit risk from the USD 600bn mortgages onto its balance sheet ([press release](#)).

Moreover a new USD 200bn lending facility (TALF) is being set up to support issuances of asset backed securities (ABS) for consumer, student and small business loans. All U. persons owning AAA rated ABS are eligible as borrowers. The lending will be on a non-recourse basis, with ABS as collateral. The borrowers must accept a haircut on the ABS, when using the lending facility. As a buffer for potential losses at the Federal Reserve, the Treasury has deposited USD 20bn from the TARP funds at the credit facility ([see press release here](#)).

Assessment & Outlook: Today's measures are a bold signal that the Federal Reserve is very serious about the message from the October minutes that they will "...take whatever steps are necessary to support the recovery of the economy". The Federal Reserve has now moved to full scale quantitative easing. In fact the recent actions by the Federal Reserve to shore up the credit crisis have followed the script from Bernanke's '[helicopter speech](#)' from 2002 relatively close. While it is not all clear, we think that today's moves increase the likelihood that the Fed will take fed funds rates all the way to zero. We believe today's action reduces the probability of a very grim economic scenario.

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