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Fixed Income Commentary

Fed Mulls New Stimulus, Mentions the “D” Word

This week’s release of the Federal Reserve Open Market Committee (FOMC) minutes from the June 22-23rd meeting provided investors with a glimpse into the slight changes in the Fed’s thinking. Specifically, the Committee has lowered its growth expectations and begun discussing possible new stimulus activity in the event it is warranted. The committee also discussed the possibility of further declines in housing prices and the risk of deflation. The minutes indicate, however, that the committee is split on the issue of how weak the recovery is, and how great the risk of further economic decline.

That said, our main headline from the minutes is that they paint a picture of a Fed that will remain on hold for quite some time, with market participants now looking for the Fed to keep interest rates unchanged at historically low levels for another 12 months.

Highlights of the minutes, by topic:

Regarding the overall health of the economy: “...the pace of the expansion over the next year and a half was expected to be somewhat slower than previously predicted. ... The economic outlook had softened somewhat and a number of members saw the risks to the outlook as having shifted to the downside.”

The “d” word: “A few participants cited some risk of deflation. ... Several participants noted that a continuation of lower-than-expected inflation and high unemployment could eventually lead to a downward movement in inflation expectations that would reinforce disinflationary pressures. By contrast, a few participants noted the possibility that a potentially unsustainable fiscal position and the size of the Federal Reserve’s balance sheet could boost inflation expectations and actual inflation over time.

The outlook for housing prices: “Participants judged that house prices were likely to remain flat or decline somewhat further in the near term. “

The possibility of additional stimulus: “In sum, the changes to the outlook were viewed as relatively modest and as not warranting policy accommodation beyond that already in place. However, members noted that in addition to continuing to develop and test instruments to exit from the period of unusually accommodative monetary policy, the Committee would need to consider whether further policy stimulus might become appropriate if the outlook were to worsen appreciably.”

Regarding the potential sale of MBS assets, the minutes state that a few participants suggested selling MBS and using the proceeds to buy Treasuries, but that “Most participants continued to judge it appropriate to defer asset sales for some time.”

For those seeking more information, we provide this link to the FOMC minutes:
<http://www.federalreserve.gov/monetarypolicy/fomcminutes20100623.htm>

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