

MONTHLY

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THE CONSISTENT FED

Introduction

The policies of Ben Bernanke and the Federal Open Market Committee have been the subject of much debate since the most recent easing cycle began in the summer of 2007. Many commentators and market participants believe that near-zero interest rates and a vastly expanded balance sheet represent a departure from past Fed policy behavior. Although the severity of the last financial crisis and economic recession did bring about unprecedented levels of monetary accommodation, we believe that the current policies are consistent with the Fed's behavior during previous economic recessions. In November of 2009, we examined Federal Reserve policy in the *Monthly* titled, "When Will Cash Rates Rise".

At that time there was a split between those who thought the Fed should raise rates immediately to head off potential inflation, and those who thought that next to zero interest rates were appropriate given their concerns about the fragility of the economic recovery. Based on our analysis at that time, we correctly forecasted that short term rates would stay anchored near zero, even though markets were pricing in monetary tightening by the middle of 2010. More recently, a dramatic rise in the prices of many commodities has given inflation hawks reason to believe that excess liquidity is becoming an inflationary problem, and again markets are beginning to price in a response from the Fed. Our own view continues to be that monetary policy is appropriate given the current state of

the economy, and that an increase in the Fed Funds rate will not occur for some time. In this *Monthly* we review the principles that we believe are most important in determining short-term interest rates, examine how the expansion of the Fed's balance sheet can be viewed in the context of past interest rate policy actions, and analyze several potential scenarios for the eventual tightening of monetary policy.

Modeling Fed Policy

The Fed has the explicit policy objectives of maintaining price stability and maximizing employment. To assure the public and elected officials that they are acting appropriately toward those ends, the Fed regularly communicates about what fac-

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CURRENT TOPIC

The Consistent Fed

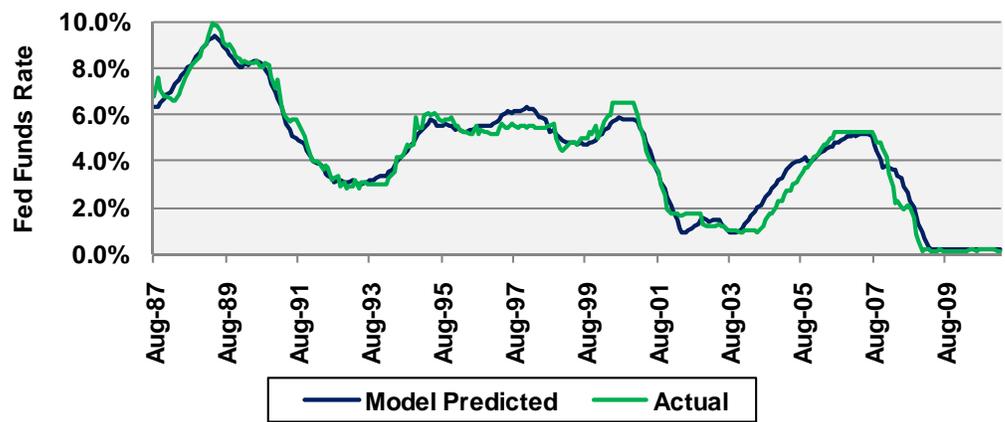
- *Introduction*
- *Modeling Fed Policy*
- *Current Monetary Policy*
- *Likely Path of Fed Funds*
- *Conclusion*

Strategy

- *We made no strategy changes during the month of March.*
- *Portfolios remain modestly overweight developed market equity exposure and underweight bond exposure.*

"THIS PROPRIETARY MODEL IS THE BASIS FOR OUR VIEW ON THE CURRENT STATE OF MONETARY POLICY"

Figure 1 - Modified Taylor Rule Model



Sources: Federal Reserve Bank, Stairway Partners

THE CONSISTENT FED - CONT'D

tors drive their monetary policy decisions. Through the years, the Fed has become more open about their deliberations and under the leadership of Ben Bernanke has dramatically increased their level of transparency. As a result of this transparency, it is possible to accurately model Fed behavior using publicly available information. We have constructed a model based on the Taylor Rule, which is a widely accepted monetary policy tool created by Dr. John Taylor in 1993. The Taylor Rule provides a level of interest rates that is deemed appropriate for a given level of inflation and excess economic capacity. The historical performance of our Modified Taylor Rule Model

is shown in Figure 1. Over a 24 year period, our model has been able to explain 97% of the movement in the Fed Funds rate. This proprietary model, which was detailed in the previously mentioned *Monthly*, is the basis for our view on the current state of monetary policy, and is the tool that we use to analyze changes that may occur in the future.

Current Monetary Policy

Currently, our model estimates a 0.25% level for the Fed funds rate, which is consistent with the Fed's stated policy range of 0% to 0.25%. Neither this forecast nor the Fed's rate policy have changed since the first

quarter of 2009. While the forecast has been accurate, more insight into Fed policy can be gained from looking below the surface of the model. The 0.25% estimate represents the minimum level for the Federal Funds rate allowed by our model. The reason that we specify a minimum cash rate is that a small amount of interest is required to allow the banking system to function without an increased level of intervention. Positive cash rates provide a natural incentive for settling securities and banking transactions in a timely manner. If we look at our model output without the minimum interest rate constraint, it would predict a Fed Funds rate of roughly

negative 5%. This negative result implies that accommodation beyond what can be achieved by lowering the Fed Funds rate is required.

Figure 2 shows the *unconstrained* model output through time relative to the model forecast and the actual Fed Funds rate. The figure shows that prior to this cycle, the economic objectives of the Fed could be met through the implementation of interest rate policies alone. Unfortunately this time, an unprecedented lack of core inflation and an abundance of excess economic capacity argued for accommodation beyond what the Fed could provide through traditional measures, given the

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Figure 2 - Fed Funds Rate

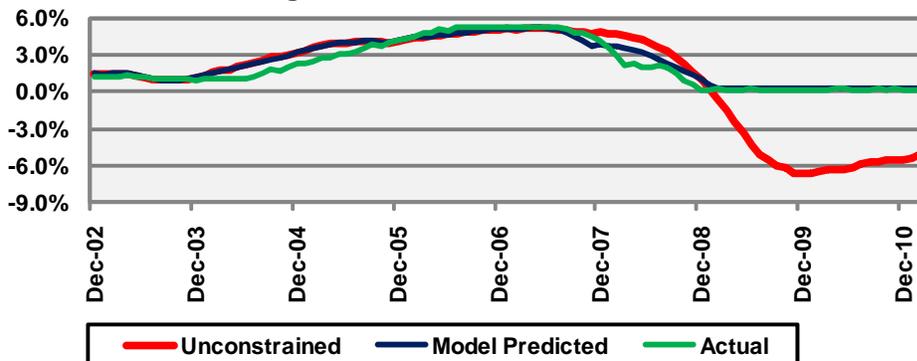
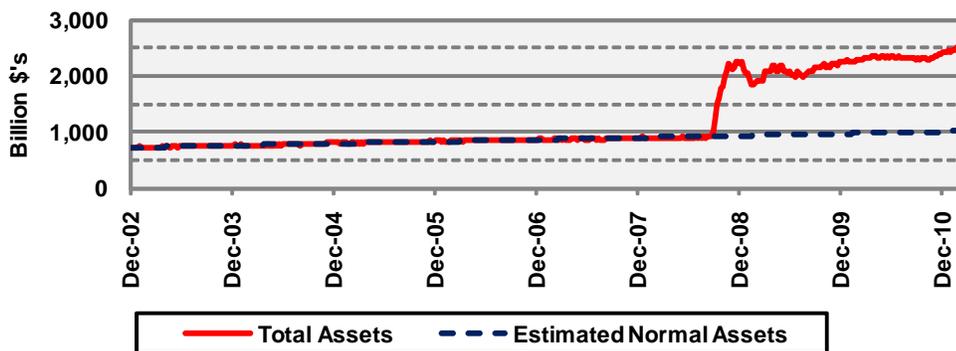


Figure 3 - Fed Balance Sheet



“PRIOR TO THIS CYCLE, THE ECONOMIC OBJECTIVES OF THE FED COULD BE MET THROUGH THE IMPLEMENTATION OF INTEREST RATE POLICIES ALONE”

*

“THIS EXCESS LIQUIDITY IS EFFECTIVELY TAKING THE PLACE OF 5.3% OF TRADITIONAL EASING THAT COULD NOT BE ACCOMPLISHED THROUGH LOWERING THE FED FUNDS RATE BELOW ZERO”

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blue-print (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

(Continued from page 2)

need for positive interest rates. As a result, the Fed had to go beyond interest rate policies and expand the assets on their balance sheet. This balance sheet expansion, which is also known as quantitative easing, is shown in figure 3. Our analysis shows that the Fed's balance sheet is about \$1.5 trillion larger than what would be expected in normal times. We believe that this excess liquidity is effectively taking the place of 5.3% of traditional easing that could not be accomplished through lowering the Fed Funds rate below zero. Taken together, this implies that the Fed views \$280 billion of balance sheet expansion as an effective substitute for a 1% drop in the Fed Funds Rate.

Likely Path of Fed Funds

Since we believe that economic conditions drive Fed policy decisions, predicting the evolution of Fed policy requires making assumptions about the future evolution of the economic conditions. Currently, we believe that the Fed Funds rate will stay anchored near-zero until the first half of 2013. This is based on our assumption that the economic expansion continues at a pace which brings the unemployment rate down to 7% by the beginning of 2013, and that Core PCE rises to 1.7% over the same timeframe. We also assume that the balance sheet will be reduced back to a more normal level before the Fed Funds rate is materially altered. Figure 4 shows how our forecasted path compares to current

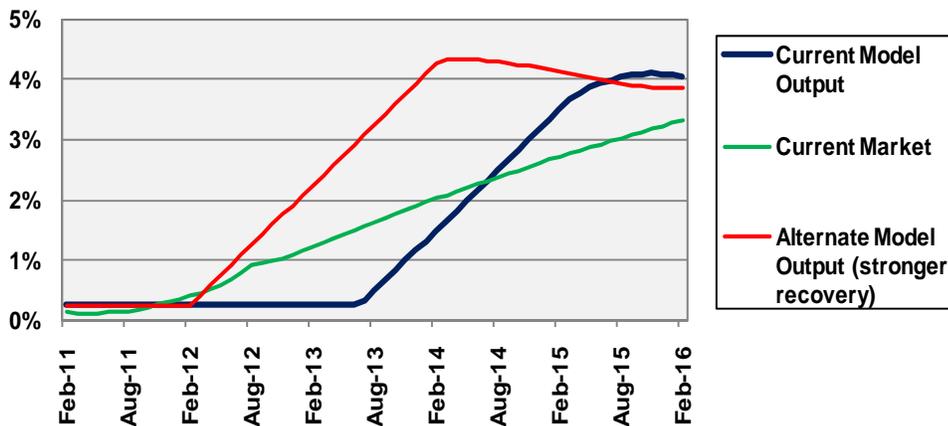
market expectations. Once again, we believe that rates will stay near-zero for longer than the general consensus which is priced into the market. For comparison, we modified our assumptions to provide a path of economic recovery which would lead to Fed policy changes closer to the markets projected increase in the first half of 2012. To achieve this result, Core PCE would have to accelerate from its current rate of 1% to roughly 2% and the unemployment rate would have to drop from 8.8% to 6.5% by the end of this year. In our opinion, these are very optimistic assumptions.

Conclusion

We believe that the Fed consistently sets policy to meet their

stated objectives of price stability and maximum employment. Based on analysis using our Modified Taylor Rule model, we believe that the Fed's policies of near-zero interest rates and quantitative easing are consistent with their past behavior. Assuming that the economic expansion continues at a moderate pace, we believe that the Fed Funds rate will remain at its current level for quite some time. Although the future is always uncertain and there is no historical precedent for the expansion of the Fed's balance sheet, we are confident that the market is again underestimating the amount of time that it will take for the Fed to materially alter their rate policy.

Figure 4 - Projected Future Fed Funds Rate



“CURRENTLY, WE BELIEVE THAT THE FED FUNDS RATE WILL STAY ANCHORED NEAR ZERO UNTIL THE FIRST HALF OF 2013”

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment																				
Equities																								
US	11.4%	4.2%	over	Exposure above benchmark weight due to attractive pricing																				
Non-US Developed			over	Exposure above benchmark weight due to attractive pricing																				
Eurozone	25.7%	4.8%																						
Japan	0.7%	3.8%																						
UK	26.1%	4.9%																						
Emerging	3.2%	10.0%	neutral	Asset class is modestly above fair value																				
Fixed Income																								
US Treasury Bonds			under	Most Treasuries expensive, other sectors offer better value																				
2-Year	0.5%	0.8%																						
5-Year	-0.1%	1.2%																						
10-Year	0.1%	1.5%																						
30-Year	0.5%	1.7%																						
US Municipal Bonds			under	In most maturities, municipal bonds are close to fair value																				
2-Year	0.4%	0.7%																						
5-Year	0.1%	1.0%																						
10-Year	1.7%	1.3%																						
20-Year	6.0%	1.5%																						
US High Yield	2.1%	2.3%	over	Sector is close to fair value																				
Non-US Government Bonds			under	Yields remain below fair levels																				
Euro 10-Year	0.0%	1.4%																						
Japan 10-Year	-3.2%	1.4%																						
UK 10-Year	1.2%	1.4%																						
Canada 10-Year	-0.3%	1.5%																						
Emerging Markets Debt	1.2%	2.5%	under	Sector is close to fair value																				
Cash	0.6%	---	minimal																					
<table style="width: 100%; border: none;"> <tr> <td></td> <td style="text-align: center;">Expected</td> <td style="text-align: center;">Equity</td> <td style="text-align: center;">10-Year</td> <td></td> </tr> <tr> <td></td> <td style="text-align: center;">FX Change</td> <td style="text-align: center;">Return with</td> <td style="text-align: center;">Bond Return</td> <td></td> </tr> <tr> <td></td> <td></td> <td style="text-align: center;">Currency</td> <td style="text-align: center;">with</td> <td></td> </tr> <tr> <td></td> <td></td> <td></td> <td style="text-align: center;">Currency</td> <td></td> </tr> </table>						Expected	Equity	10-Year			FX Change	Return with	Bond Return				Currency	with					Currency	
	Expected	Equity	10-Year																					
	FX Change	Return with	Bond Return																					
		Currency	with																					
			Currency																					
Currencies																								
Euro	-6.1%	18.0%	-6.1%	Euro is modestly above fair value																				
Japanese yen	-1.8%	-1.1%	-5.0%	Yen is near fair value																				
UK pound	-2.3%	23.2%	-2.6%	Pound is near fair value																				

Notes:
As of: March 31, 2011

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.

The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).

The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.

Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.

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