Federal Funds rate: 0%-0.25%. Consensus: Unchanged

Q.E.

The Fed ceased their Q.E. Programme at the end of March. The chorus of calls for the Fed to re-embark on their Q.E. Programme has been deafening recently. In fact markets are now expecting the Fed to signal that they will restart their Q.E. Programme at this meeting. Any change here is likely to have a significant impact on Treasuries. Markets have priced in that the Fed will recycle profits made from matured MBS debt and role it into treasury buybacks. The Fed may signal this by committing to maintain the size of their current balance sheet. At its peak this was around $2.3 trillion. If the Fed decide that they wish to commit further funds towards buying Treasuries and other debt, they should state the size and its impact on their balance sheets. There are possibly three distinct scenario risks to look out for. 1) the Fed will maintain their current balance sheet and commit the money they receive from expired debt towards buying more debt. 2). The Fed will commit to increasing the size of their balance sheet. 3). The Fed will remain on a wait and see stance. If scenarios 1 and 3 occur, we would expect the USD to strengthen and the USTs and equity markets to sell-off. If *scenario 2* occurs, we would expect a positive reaction from Bond and equity markets, and be negative for the USD. However the call on the USTs is mainly a very short-term buy as in the long term this should diminish the tail risks of deflation in the near term.

The expired programme stood at **$1.25 Trillion Agency MBS, and $175 Bln of agency debt.** The **treasury buy-back programme was $300 Bln**. There is talk of the Fed outlining a $2 Trillion Q.E. Package. This would be scenario 2, and the "nuclear option" that markets are hoping for.

The economy

We are looking out for the Federal Reserve's outlook on the economy. We feel that the Fed may **downgrade their view on the economy**- previously "**deterioration in labor markets is abating**…*Household spending* **appears to be increasing**, *but remains constrained by high unemployment,* ***modest*** *income growth, lower housing wealth, and tight credit. Businesses spending on equipment and software has risen significantly* (this was upgraded last time)… *(they) have brought inventory stocks into better alignment with sales… Financial conditions remain supportive of economic growth*". However the FOMC have **maintained a cautious stance**- at the last meeting they stated that, "**the pace of recovery** is likely to be **moderate** for a time". (This too was upgraded from "*economic activity is likely to remain weak*").

The Fed have previously stated that they see **inflation to remain "*subdued for some time*".** We do not expect a change to this statement.

Although at the Humphrey Hawkins testimony, Bernanke maintained the Fed's previous forecast of 2010 GDP at 3.7%, despite being more downbeat on the current economic assessment.

Zero Interest Rate Policy (ZIRP)

The Fed's official strap-line for their current monetary policy is "**economic conditions, including low rates of resource utilisation, subdued inflation trends, and stable inflation expectations… warrant Federal Funds rate… at *exceptionally low levels…* for an extended period".** If there is to be any changes to the policy, it may be here. Any change to this statement may imply a change to the FOMC policy towards keeping rates low for longer. It is very unlikely that the Fed will look towards exiting their easy monetary policy at this meeting in particular as the Fed remains sensitive towards the potential market-wide consequences.

Other forms of easing

There has been talk that the Fed may shift their focus to setting the **interest paid on reserves rate to ease policy rates.** In theory this will allow them control liquidity in the market more easily. The stark change would be that in previous month's participants had been speculating that the Fed will hike this rate to start their exit policy.

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