Investment Strategy Update

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How much more can the Fed pump into the system?

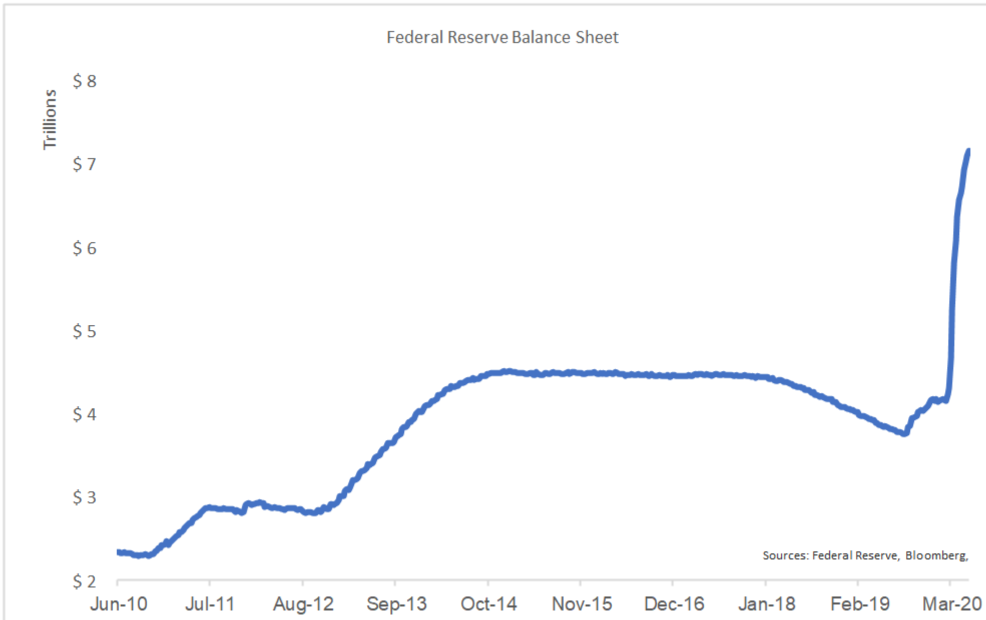
♦ Investors watch rate-setting meeting for clues on the speed at which the Federal Reserve will continue to expand its balance sheet.

♦ The central bank is likely to signal that it will keep rates at zero for a very long period of time.

♦ Stock markets take a breather as they await for the Fed's decision and forward guidance on interest rates .

♦ Nasdaq touched an all-time high yesterday as investors show themselves willing to pay higher premiums for growth.

♦ FAB AAC remains overweight high quality investment grade bonds.



The Federal Reserve has been applauded for its swift and forceful response to the global crisis caused by the great lockdown. Indeed, mostly thanks to it, stocks have moved all the way back to where they were at the beginning of the year and the Nasdaq, which is dominated by shares of technology companies, has hit a new record. Perhaps more important, a funding squeeze has been completely dispelled with Libor rates as well as other indicators moving back to normal.

The financial market recovery has been so swift that some are now questioning whether it makes sense for the Fed to continue with quantitative easing at the pace that it has. In the past three months the Fed has added US$2.9 trillion of assets to its balance sheet, buying up everything from auto-loans and mortgages to high-yield bonds and ETFs. It still can add a lot more, but given how well markets are doing, the Fed may slow down.

Not that there are any doubts that the Fed will continue to support financial markets. In fact, one of the things that investors will watch keenly tomorrow, when the Fed announces its monetary policy decision, is the central bank's projection for interest rates. After not releasing their economic projections in March, Fed governors will update them tomorrow, and the world will see a new 'dot-plot'. Given how long the economic recovery is likely to take, the Fed will probably signal that zero rates will remain in place for many years.

It might, however, also feel the need to curb the enthusiasm in markets a bit in order to avoid a bubble. Any further stimulus is more likely to focus on the central bank's Main Street Lending Program, which was already expanded on Monday to make it easier for small and medium-sized companies to borrow under it. The Fed has a dual mandate of keeping inflation and unemployment in check, and right now the latter is at a record.

The Fed has added US$2.9 trillion to its balance sheet in only three months

The main risk now is that the stimulus already enacted has been so effective that both Congress and the Fed may be reluctant to continue to add more. And many of the programs start to expire this month and next, including one-time payouts and beefed up welfare checks.

While Wall Street has mostly recovered from the pandemic, Main Street is far from it. Unemployment remains at 13.3% near the highest since 1948. And while many economic indicators have shown rapid recovery, they remain way below where they were a year ago, prompting the OECD to predict the world will contract by 6% this year. Even if the Fed slows down, it is too early for it to stop printing money.

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