QUANTITATIVE EASING: THE FED'S TOUGH DECISION

Around the world, financial markets have been talking of little else for weeks. On Wednesday, the waiting game finally comes to an end.

REUTERS/ KEVIN LAMARQUE

BY PEDRO NICOLACI DA COSTA
WASHINGTON, OCT 21

ONE HUNDRED BILLION here, one hundred billion there. Pretty soon we're talking real money.

It may not be "shock and awe" at first blush, but the ultimate sums involved in a second, widely anticipated program of Treasury bond buying from the Federal Reserve could ultimately rival the hefty first round of asset purchases.

With expectations of at least $500 billion already built into financial markets, the Fed may try to counter possible disappointment by making its commitment open ended.

It will likely do so by setting parameters vague enough to convince the markets that, like its promise to keeping interest rates low, the second round of so-called quantitative easing will be around for an "extended period" if needed.

The rationale for further monetary accommodation has been laid out by Chairman Ben Bernanke, whose views on policy carry the day at the Federal Open Market Committee.

"DEPENDING ON EVOLVING ECONOMIC AND FINANCIAL CONDITIONS, QE2 HAS THE POTENTIAL TO GROW QUITE LARGE."

He has made clear that, with the 9.6 percent unemployment rate far above what might be seen as normal even in a post-recession context and inflation dangling at uncomfortably low levels, policymakers deem the risk of an outright deflationary rut significant enough to justify action.

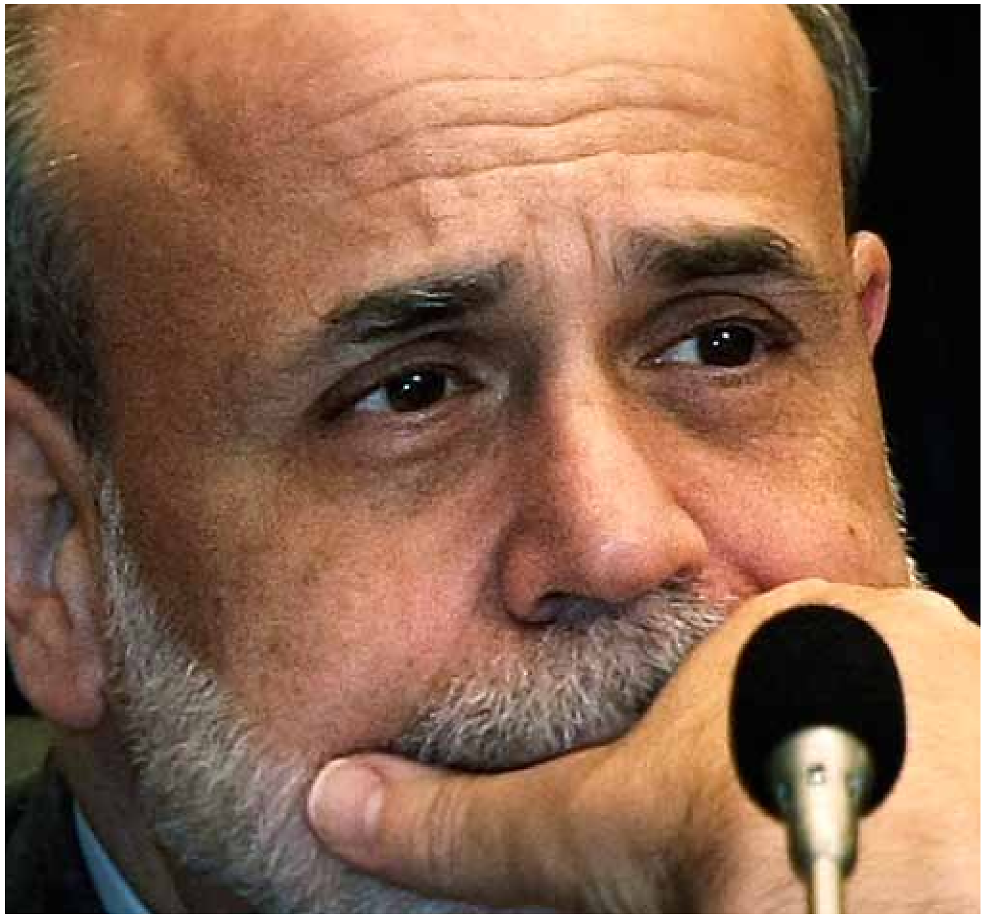
An incremental, flexible approach serves two purposes.

First, it seems commensurate with an economy that, while sluggish, is still growing, giving the Fed room to dial the pace of buying up or down depending on economic conditions.

An earlier round of unorthodox Fed easing, which totaled $1.7 trillion and centered primarily on mortgage-linked debt, was meant to quell a free fall rather than shake economic activity out of a slumber.

"Depending on evolving economic and financial conditions, QE2 has the potential to grow quite large," said Dana Saporta, economist at Credit Suisse in New York. "The FOMC may choose to introduce forward guidance that would achieve the same effect of a 'shock and awe' strategy while not committing policymakers to any specific purchase total."

The second benefit of a more cautious initial announcement would be to engender unanimity where it may be lacking. Given the untested nature of the new policy, some inflation hawks at the Fed have vocally opposed further easing in recent weeks.



DECISION TIME: U.S. Federal Reserve Chairman Ben Bernanke attends the G20 Finance Ministers and Central Bank Governors meeting in Gyeongju October 22, 2010. **REUTERS/AHN YOUNG-JOON/POOL**

CHASING SHADOWS

AS FOR THE PACE of buying, two regional Fed presidents indicated this week the Fed would parcel out its buying in monthly installments of $100 billion, cementing market expectations for such a sequence.

Ever cognizant of expectations, the Fed could overshoot the market's $500 billion base case in order to get the ball rolling and achieve the desired market effects.

For many of the Fed's most influential members, bond purchases stimulate growth by forcing investors to buy higher yielding, riskier assets like equities and corporate bonds, driving down the cost of capital for U.S. firms.

This view might call for larger initial purchases than the market has already taken for granted, even if the game of chasing market expectations has its dangers.

"There is a potentially unstable ... dynamic in which the FOMC has an incentive to go a bit farther than markets anticipate while the markets -- knowing this -- periodically raise the bar," said Andrew Tilton, economist at Goldman Sachs.

While median forecasts in a Reuters poll of 27 analysts released last week pointed to $500 billion in easing, the average was closer to $650 billion. Forecasts in a separate poll of U.S. primary dealers earlier this month topped out at $1.5 trillion. [FED/R]

SHOOTING FOR TARGETS

ANOTHER WAY TO DEFLECT concerns that the Fed is laying the groundwork of future inflation by further expanding credit to the banking system, already three times pre-crisis levels, is to make explicit the Fed's presumed anchor for inflation of around 2 percent.

A numerical goal would at once boost inflation expectations, pushing consumers and businesses to spend, but also set a tangible upward boundary for the extent of quantitative easing.

This is a boundary that could win over hawks like Charles Plosser of the Philadelphia Fed, who are skeptical about central bankers' ability to influence any key indicators other than inflation.

Still, the Fed's November meeting may be a bit too early to expect anything in the way of a concrete inflation goal. Discussion by some FOMC members of a bolder, price-level target that would allow the Fed to temporarily overshoot its goal suggests the issue remains very much in flux.

While Bernanke singled out 2 percent "or a bit below" as the appropriate inflation rate to shoot for, the more hawkish Jeffrey Lacker argued 1.5 percent would be better, adding that a policy statement is too fleeting a place for a benchmark meant to offer a sense of permanence and stability.

TREASURY PURCHASES MAY START AT $500 BILLION

St. Louis Fed prefers incremental purchases to maintain flexibility

BY MARK FELSENTHAL AND KRISTINA COOKE
ST. LOUIS, OCT 22

FEDERAL RESERVE OFFICIALS are considering easing that could start with $500 billion, and progress in increments as high as $250 billion, but worry how such a move would be perceived, according to a top adviser for the St. Louis Federal Reserve.

"There's a lot of momentum and support to do something," Christopher Waller, director of research at the St. Louis Fed, told Reuters in an interview.

"IT DEPENDS WHAT YOUR OBJECTIVE FUNCTION IS AND WHAT YOUR ESTIMATES FOR THE EFFECTS ARE. I THINK IT'S A LOT OF GUESSWORK. WE DON'T REALLY KNOW. "

"It's just how huge, and is it going to be time-dependent or state-dependent. ... The likelihood we do something is probably pretty high," he said.

The Fed, which cut rates to near zero and bought $1.7 trillion in securities, is widely expected to renew an easing program at its Nov. 2-3 meeting. Fed Chairman Ben Bernanke has said that high unemployment and low inflation appear to meet requirements for further Fed action.

Waller's comments, in a rare on-the-record interview with an aide who is present at discussions of the U.S. central bank's policy-setting Federal Open Market Committee, suggest a lively debate in the Fed on the scope of easing, with discussion encompassing options as extensive as $1.5 trillion over a year -- tempered by worry a too-aggressive strategy could backfire if investors perceived the U.S. central bank was monetizing the national debt.

NO NEED: President of the Federal Reserve Bank of Philadelphia Charles I. Plosser gives a speech during the European Banking & Financial Forum 2010 in Prague March 23, 2010. **REUTERS/DAVID W CERNY**

Many market participants had been expecting an easing program of about $500 billion.

An important principal in the debate, Philadelphia Fed President Charles Plosser, said there are different views within the Fed about whether a small step or a big-bang approach would be more effective.

Plosser, who has said repeatedly he does not see the need for the Fed currently to buy more assets, said the views depend on how policymakers see the purchases working and what they are trying to achieve -- be it nudging up inflation or lowering the unemployment rate.

"It depends what your objective function is and what your estimates for the effects are. I think it's a lot of guesswork. We don't really know. So that makes the policy decision extremely difficult," Plosser told reporters in Philadelphia.

Plosser has a reputation for being among those most concerned about holding inflation at bay at all costs.

St. Louis Fed President James Bullard, viewed as a centrist between inflation-focused hawks and full employment-prioritizing doves, said that if the Fed decides to ease monetary conditions, he would favor incremental purchases of about $100 billion of Treasury securities, without setting an outer limit on the total amount of purchases.

Waller said the St. Louis Fed vastly prefers incremental purchases to maintain flexibility as the economy evolves and that an approach under discussion is to buy as much as $250 billion from one meeting to the next, roughly the equivalent of a quarter-point move in short-term interest rates.

Policy-makers take as a rough estimate that $100 billion in Treasury purchases would reduce the yield on the benchmark 10-year Treasury note by about one-tenth of a percentage point, Waller said.

"There's a lot of credibility to it that if we were going to (move) the fed funds rate 25 basis points meeting to meeting ... that's kind of like a $250 billion purchase intermeeting," Waller said. "The only thing that's tempering that number back for us is we're worried about the optics of that in terms of monetizing the deficit."

One possibility would be to launch the Fed's first move with a larger purchase and scale back the increments after that, he said.

"You could make the argument for the first meeting you may want to go bigger than that, which would be the equivalent of a 50-basis point cut, that would be $500 billion," Waller said. "And then after that, you do smaller increments."

Fed officials worry, however, that purchases in the neighborhood of $1.5 trillion over the next year would look like the central bank is printing money to pay for the U.S. budget deficit. "That scares people," Waller said.

THE WALL STREET VIEW

BOND BUYER: U.S. Chairman of the Federal Reserve Ben Bernanke takes part in an interview at the Woodrow Wilson Center Board and Council Dinner at the Ronald Reagan Building and International Trade Center in Washington, June 7, 2010. **REUTERS/JIM YOUNG**

BY CHRIS REESE
NEW YORK, OCT 27

MOST LEADING ECONOMISTS expect the Federal Reserve to buy between $80 billion and $100 billion worth of assets per month under a new program to bolster the struggling economy, a Reuters poll found on Wednesday.

Estimates for how long the Fed will print money and how much it will eventually spend varied widely, from $250 billion to as high as $2 trillion. In a similar Reuters poll of primary dealers conducted on Oct. 8, dealers mostly forecast the total size of the new program at $500 billion to $1.5 trillion.

"The key question is not the size of the first step, but how far Fed officials will ultimately need to move to achieve their dual mandate of low inflation and maximum sustainable employment," said Jan Hatzius, chief U.S. economist at Goldman Sachs in New York. Goldman estimates the eventual size of the second program of quantitative easing could reach $2 trillion, at the high end of economists' forecasts.

The economists think the impact of the asset buying could be limited given that markets have already priced in the effect of another big round of monetary stimulus.

The median of forecasts from economists at primary dealers pegs benchmark 10-year Treasury note yields at 2.65 percent as of mid-2011, near their current level of about 2.62 percent.

Lower Treasury debt yields, which are a benchmark for interest rates like those on mortgages, will be considered a key gauge of success for the new quantitative easing program.

Seventeen of 18 primary dealers responded to the poll, with all saying they expect the Fed to announce another program of quantitative easing -- dubbed QE2 -- at the close of the Fed's policy meeting on Nov. 3. While seven of 10 economists who replied to the question said QE2 will pull 10-year Treasury yields lower, several economists said they believed rates already had come down because of the looming prospect of more Fed purchases.

"I would argue that quantitative easing already has worked -- you have seen in terrific improvement in U.S. financial conditions over the last few months including a weakening of the dollar, lower U.S. interest rates and a strengthening of stock prices," said Zach Pandl, U.S. economist at Nomura Securities International in New York. "A lot of that has been brought about by quantitative easing and the market pricing it in to an extremely high degree."

Benchmark yields are historically low. Earlier this month the benchmark yield dipped to 2.33 percent, the lowest since December 2008, the height of the global credit crisis.

Quantitative easing is not an unfamiliar road for the Fed. The U.S. central bank previously bought about $300 billion of longer-term Treasury securities from March through October 2009 as part of its efforts to combat the U.S. recession.

Including mortage-related debt, the Fed has bought a total of $1.7 trillion in assets to prevent the U.S. financial crisis from turning into a depression. With the recovery still weak, policymakers have said they are ready to take more action.

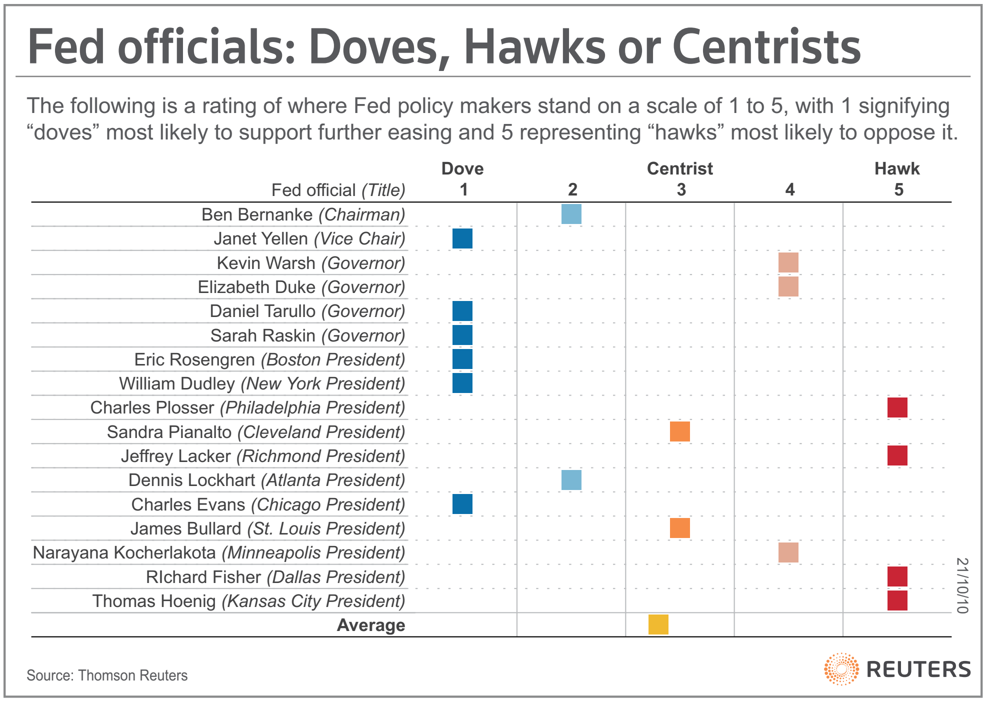
HOW THE DECISION COULD PLAY OUT

BY PEDRO NICOLACI DA COSTA
WASHINGTON, OCT 26

FED OFFICIALS HAVE offered conflicting signals on their policy predilections in recent weeks, with some pushing for a very aggressive stimulus and others highly skeptical of any additional accommodation.

This makes it harder to gauge where the ultimate consensus will settle, though most analysts assume Fed Chairman Ben Bernanke's dovish leanings will carry the day.

Here are some ways in which next week's decision might play out:



Reuters graphic/Van Tsui

$500 BILLION OVER FIVE MONTHS, HINTS OF MORE

This is the base-case scenario for financial markets -- investors may have already priced in even more, in fact. Any disappointment at the headline figure, however, would likely be more than offset by any nod to the possibility of further purchases if conditions warrant. That would be interpreted as an open-ended promise to do whatever it takes to ensure the recovery is on track and spark rallies in U.S. stocks and government bonds. The dollar, which has been gaining ground this month, would suffer.

$750 BILLION TO $1 TRILLION, HINTS OF MORE

The Bernanke Fed has shown a propensity for erring on the side of going big. This is based on the notion that policy acts with a lag and that fighting inflation is easier than battling deflation. The Fed could choose to go beyond market expectations in order to build in an extra "announcement effect," in the same way that intermeeting rate cuts are believed to offer more bang for the buck. This would lead to a sharp rally in riskier assets like stocks and emerging market bonds. Commodities would also rise sharply as investors worry about the possibility of an unruly dollar decline.

OPEN ENDED, WITH NO UPFRONT COMMITMENT

Given opposition within the FOMC from hawks, it is not inconceivable that the Fed will find it hard to settle on a large upfront commitment. Instead, the Fed could announce purchases of about $100 billion a month, a figure that has already been cited by at least two top Fed officials, but hint at intentions to do more as economic conditions evolve. This approach might have the added benefit of helping to quell concerns from other countries that the United States was engaged in competitive devaluation of its currency. Market reaction to this outcome is harder to predict and would depend greatly on how the Fed characterizes the economy in its policy statement.

$500 BILLION TO $750 BILLION, WITH NO HINT OF MORE

Perhaps the best way to win over skeptics is not to limit the initial amount of easing but rather to put a cap on its ultimate size. With Fed credit to the banking system already at $2.3 trillion, triple pre-crisis levels, some officials worry that an eventual exit from this ultra-easy stance will be made increasingly difficult with a larger balance sheet. However, it is hard to imagine the Fed would embark in such an unorthodox policy without giving itself the flexibility to follow through on its efforts to spur a sustainable recovery.

A SMALL, FINITE COMMITMENT

This is the least likely outcome. Markets have not priced in a significant easing in a vacuum. Fed officials, including Bernanke, have been careful to telegraph the central bank's intentions. By disappointing these expectations so severely, the Fed would risk undoing the lowered yields garnered by jawboning alone, potentially jeopardizing an already fragile recovery. The dollar would benefit, but at the expense of bonds, stocks and emerging market securities.

CENTRIST: St. Louis Federal Reserve Bank President James Bullard is seen in this undated handout photograph. U.S. Federal Reserve policy-makers on July 29, 2010 said the economic outlook remained uncertain and the country's subprime mortgage market would remain moribund for some time. **REUTERS/ST. LOUIS FEDERAL RESERVE BANK/HANDOUT**

FACTBOX

HAWKS AND DOVES FIGHT IT OUT

A CONSENSUS APPEARS to be in place at the Fed in favor of a second round of purchases of U.S. government debt to stimulate the economy, with a number of officials firming their support or showing more openness toward easing in recent weeks.

Supporters of more quantitative easing, labeled doves, include Fed presidents in New York, Chicago and Boston. Several see a very low inflation rate, lack of momentum in the economy and worries over deflation.

Other Fed officials have reluctantly come around to the idea of more easing, though some have outright warned such a move was dangerous and unlikely to fix the U.S. jobless problem.

INTERACTIVE

For an interactive map of where policy makers stand click here http:

http://r.reuters.com/ryv97p

ALL TOGETHER: Federal Reserve Board Chairman Ben Bernanke (C) poses with board members at a two-day meeting of the Federal Open Market Committee, the Federal Reserve's interest rate-setting body, in Washington in this March 17, 2009 picture released on March 19, 2009. **REUTERS/JOE PAVEL/FEDERAL RESERVE BOARD/HANDOUT**

NOT ALL BAD FOR U.S. DOLLAR

Fed seen as a driver of growth

BY NICK OLIVARI AND STEVEN C. JOHNSON
NEW YORK, OCT 27

THE PROSPECT OF another dose of quantitative easing from the Federal Reseve may be bad for the dollar in the short term, but some investors are already betting a U.S. economic recovery and rising inflation will change the greenback's fortunes.

While the new purchases would be a hefty addition to the Fed's balance sheet after it cut interest rates to near zero in 2008 and then bought $1.7 trillion of longer-term securities to pull the economy out of recession, the new measures are likely to bolster growth, analysts said.

"Some hedge funds are looking at it as the Fed comes in to drive growth in the economy, and that means only one direction for the stock market and the dollar. That is strength," said Dean Malone, a currency director at Compass FX in Dallas, Texas. The dollar index, a calculation of the dollar's performance against six currencies, is flat for the year to date, and the Standard & Poor's 500 index has risen 5.7 percent -- hardly signs that investors are not betting on profits

WELCOME: Janet Yellen is sworn in as a Federal Reserve Board governor by U.S. Federal Reserve Chairman Ben Bernanke (L) in the Board Room of the Eccles Building in Washington October 4, 2010 **REUTERS/BRITT LECKMAN**

from U.S. companies or that the dollar will weaken further.

There are also clear technical signs that the dollar's fortunes are already changing. The euro/dollar has flirted with the $1.400 level several times in recent days but has only managed to close above it once.

Sell signals on several major currencies against the dollar were triggered on either Oct. 18 or 19 when the 12-day and 26-day moving average convergence/divergence line moved below the nine-day signal line, according to Reuters data. Conversely, buy signals on the dollar were triggered on the same dates against the Swiss franc and the Canadian dollar. The MACD is used in technical analysis as an indicator of short-term momentum by focusing on exponential moving averages and closing prices.

The dollar will also get a boost, particularly against the euro, the second most actively traded currency, because of the relative central bank positions.

"Once austerity measures take shape in Europe, the economy may contract relative to the U.S.," said Mark McCormick, currency strategist at Brown Brothers Harriman in New York. "The base scenario, with fiscal tightening taking place in the euro zone, should slow down the euro's momentum and probably slow down the talk of higher interest rates, which has been a source of euro strength."

"The ECB is more willing to raise rates at lower growth levels while the Fed is more aggressively easing," said David Kupersmith, head trader at Third Wave Global Investors, a global macro hedge fund in Greenwich, Connecticut. "Higher growth may mean the Fed will change its path. Higher growth will lead them to stop QE or reverse it."

All of which would be good for the dollar.

But additional fuel for a dollar rally comes from extreme bets against the currency, which will have to be reversed once any rally starts. While currency speculators have reduced bets against the U.S. dollar, net short positioning on the dollar against major currencies is still at extreme levels, according to data from the Commodity Futures Trading Commission.

To be sure, the dollar is expected to be volatile until the Fed completely clarifies details of its QE program, particularly the amount. The volatility will be even greater later if the Fed does not begin to retrieve the liquidity once the economy turns around.

OPINION

THE RISKS OF CORNERING THE TREASURY BOND MARKET

BY JOHN KEMP
LONDON, OCT 28

COMMENT ON A SECOND round of quantitative easing has focused almost entirely on the buyer (the Federal Reserve) and the volume of Treasury securities it needs to purchase to achieve its stated goals (boosting inflation and closing the output and employment gaps).

Far less attention has been given to identity of the sellers or how many the bonds the Fed can buy before it disrupts or even corners the market. The focus has been macro rather than micro. It has treated the bond market as if it was an undifferentiated, limitless ocean.

But while the market in U.S. Treasury securities may be the largest and most liquid for any financial instrument, liquidity is still finite, which imposes real restrictions on the scale and target of balance sheet expansion policy.

First, the Fed must find someone to sell it the securities. Too much comment has assumed there are unlimited notes and bonds simply floating around waiting for the Fed to buy them.

In fact, every single note and bond of the $8.475 trillion worth of marketable U.S. Treasury securities outstanding at the end of September was owned by someone (the Fed, a bank, a foreign government, a private investor or an institution such as a pension fund) who had deliberately chosen to include it in their portfolio.

The Fed also must either buy from private investors or from foreign governments.

Buying Treasuries from governments would provide an exit strategy for China, which has already cornered the market and fears it holds too much U.S. debt. But since the funds would be redeployed outside the United States it would provide limited stimulus.

Q & A

WILL THE FED DO MORE TO HELP ECONOMY?

THE U.S. FEDERAL RESERVE is mulling whether or not it should do more to spur a sluggish economic recovery and lift an inflation rate that is too low. The Fed already has bought $1.7 trillion of mortgage-related and Treasury bonds, after cutting benchmark interest rates to near zero to combat the financial crisis and help the economy pull out of a severe recession.

But given the economy's weak outlook, many analysts expect the Fed to embark upon another round of asset buying.

DISSENTER: Kansas City Federal Reserve President Thomas Hoenig speaks regarding "Ending Government Bailouts" at the American Economic Association Conference in Atlanta, Georgia January 5, 2010. **REUTERS/TAMI CHAPPELL**

WILL THE FED DO MORE TO SUPPORT THE ECONOMY?

FEDERAL RESERVE officials are still divided on whether or not to ease further.

William Dudley, the head of the Federal Reserve Bank of New York, said on Oct. 1 that more Fed action will likely be warranted if the outlook for employment and inflation does not improve.

Dudley's views, as the vice chair of the policy-setting Federal Open Market Committee, are seen as carrying more weight than other regional presidents. His view has been publicly shared by Chicago Fed President Charles Evans and Boston Fed President Eric Rosengren.

Charles Plosser, head of the Philadelphia Federal Reserve Bank, said on Sept. 29 that further Fed easing is unnecessary based on his outlook. And Dallas Fed President Richard Fisher has said in his view only another shock to the system would merit further easing.

WHAT DO FED OFFICIALS DISAGREE ON?

FEDERAL RESERVE Chairman Ben Bernanke has framed the debate on further easing in terms of a cost-benefit analysis.

This means there are many different fault lines along which Fed officials can disagree: on the outlook for the economy, the effectiveness of tools and the costs of using those tools.

Regional Fed bank presidents, including Dudley and Rosengren, say purchases can stimulate the economy by lowering borrowing costs.

But Fisher has argued that regulatory and fiscal uncertainty -- not interest rates -- is hindering business activity, putting the ball in the government's court.

Some officials, including most vocally Minneapolis Fed President Narayana Kocherlakota, have argued that much of the unemployment problem is due to a skills mismatch, which monetary policy is not best placed to address.

WHAT WOULD FED HOPE TO ACHIEVE WITH MORE EASING?

IF THE FED resumed purchases of longer-term U.S. Treasury debt, it would hope to further drive down long-term borrowing costs to spur economic growth and to nudge up below-target inflation.

In part, the Fed would want to force investors to move into other, riskier, asset classes to impact a wide range of rates.

Lower U.S. borrowing costs could stimulate home buying and building, business investment and, ultimately, hiring.

SMALL STEPS OR BIG BANG?

THE NEW YORK Fed staffer charged with implementing Fed policy, Brian Sack, said on Oct. 4 that a smaller step program would enable the Fed to be more responsive to the evolving economic outlook. This, he said, would be similar to the way it has historically adjusted the benchmark federal funds rate.

WHAT OTHER OPTIONS DOES THE FED HAVE?

THE FED COULD also clarify its intentions through its communications strategy. It could strengthen its pledge to keep rates low for an extended period. Dudley suggested that the Fed could be more explicit about its inflation objective.

FACTBOX

SHOW ME THE MONEY: Four million U.S. dollars in counterfeit bills are shown at a police station in Panama City, March 26, 2010. **REUTERS/ STRINGER**

FED EXPLORES UNORTHODOX TOOLS

HERE ARE SOME of the tools the Fed is considering as possible steps to support a flagging economy.

TREASURY PURCHASES

THE SCOPE and pace of Fed purchases remains unclear, and will be the major focus for markets ahead of the Fed's November decision. Atlanta Federal Reserve Bank President Dennis Lockhart suggested on Oct. 15 that purchases on the order of $100 billion a month might be appropriate.

The Fed appears to have backed off the idea of further purchasing of housing bonds, where it already has an overwhelming presence. Advocates of further Treasury purchases say a greater effort is needed to boost business and consumer demand. Skeptics argue the policy carries more risks than potential benefits, and could undermine the Fed's hard-earned credibility as a steward of low inflation.

INFLATION TARGET

THE U.S. CENTRAL bank may choose to set an explicit inflation target in conjunction with a policy of asset purchases. The goal would be to clearly communicate to both the public and financial markets that policymakers are committed to getting inflation back up to more comfortable levels. This could help foster expectations of higher inflation, which could have a stimulative impact since it would push inflation-adjusted interest rates lower.

LOW RATES LANGUAGE

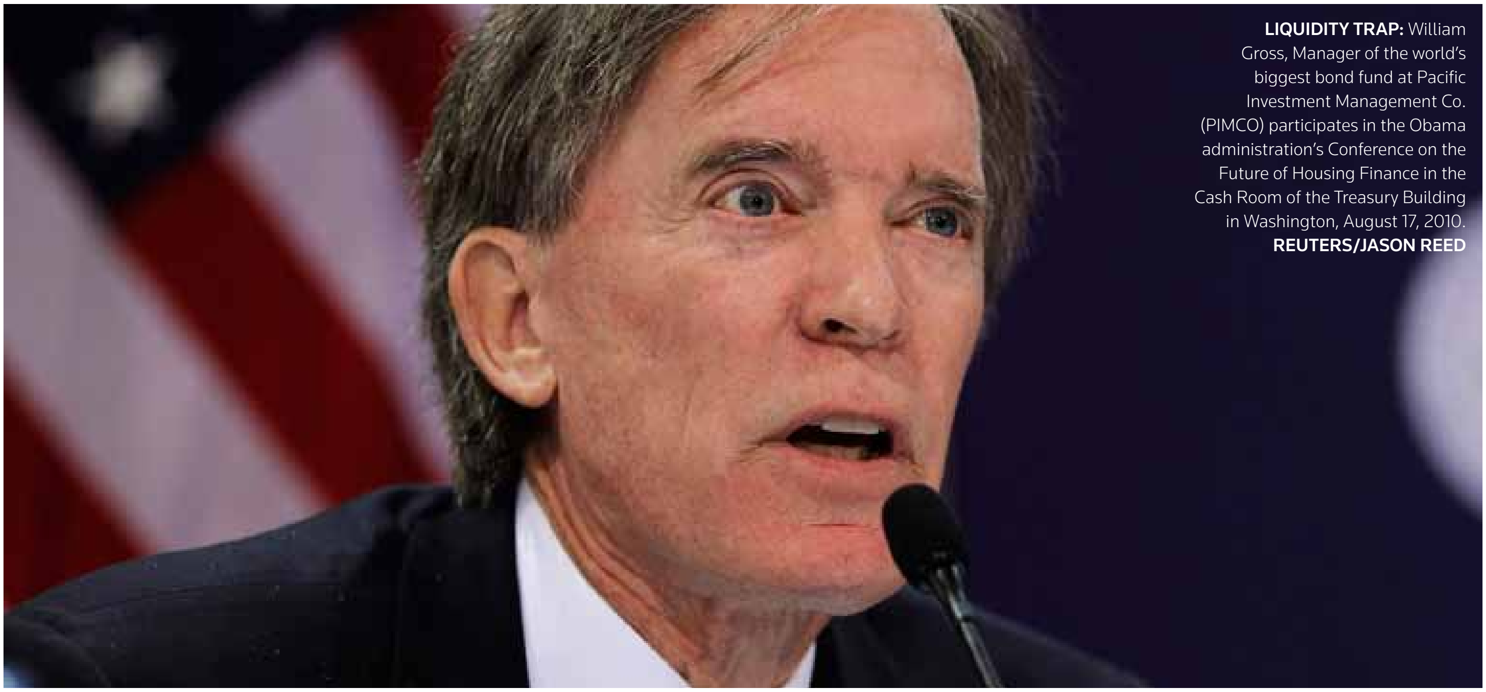
THE FED HAS said it could offer further stimulus to the economy by bolstering its commitment to keeping interest rates low for an extended period. This would force market participants to price in lower long-term borrowing costs and prompt some investors to buy riskier assets as they seek higher returns.

PRICE LEVEL, GDP TARGETING

FED MINUTES SHOWED policymakers were willing to consider other fairly unorthodox policy approaches, but their relative novelty leaves a pretty high threshold for implementation. Price-level targeting takes inflation targeting one step further. By targeting a specific price level, the Fed would promise to generate above-target inflation at times when inflation is slowing or prices falling in order to play catch-up. Like an inflation target, a price-level target could help lift inflation expectations.

SHOOT FOR EVEN HIGHER INFLATION

STAFF AT THE International Monetary Fund and a number of other prominent economists have argued the Fed should consider shooting for inflation above 2 percent as a way to raise price expectations and induce consumers and businesses to go out and spend. This approach is seen as problematic within the Fed. Policymakers worry that, once the inflation genie is out of the bottle it may be hard to get it back under control.



LIQUIDITY TRAP: William Gross, Manager of the world's biggest bond fund at Pacific Investment Management Co. (PIMCO) participates in the Obama administration's Conference on the Future of Housing Finance in the Cash Room of the Treasury Building in Washington, August 17, 2010. **REUTERS/JASON REED**

PIMCO'S GROSS BLASTS FED'S ASSET BUYING

BY JENNIFER ABLAN
NEW YORK, OCT 27

TWO TOP ASSET MANAGERS, Bill Gross, co-founder of Pacific Investment Management Co., and Jeremy Grantham, chief investment strategist at Grantham Mayo Van Otterloo & Co., lambasted the Federal Reserve's loose monetary policy and said renewed asset purchases are in danger of becoming ineffective.

The U.S. central bank's bond asset purchasing program "is in fact inflationary, and, if truth be told, somewhat of a Ponzi scheme," Gross wrote in his monthly investment outlook posted on Pimco's website on Wednesday.

"It raises bond prices to create the illusion of high annual returns but ultimately it reaches a dead end where those prices can no longer go up," said Gross, who manages the world's largest bond fund.

Gross said the United States is in "'a liquidity trap,' where interest rates or trillions in asset purchases may not stimulate borrowing or lending because consumer demand is just not there."

Grantham, who helps oversee over $100 billion at Grantham Mayo Van Otterloo & Co., said Fed policy has resulted in "extraordinary destructiveness" and "ruinous cost."

"I would force (the Fed) to swear off manipulating asset prices through artificially low rates and asymmetric promises of help in tough times -- the Greenspan/Bernanke put," Grantham wrote to clients, referring to Fed Chairman Ben Bernanke and his predecessor, Alan Greenspan. "It would be a better, simpler and less dangerous world, although one much less exciting for us students of bubbles."

Gross, who helps oversee more than $1.1 trillion in assets at Pimco, said the resumption of asset purchases by the Federal Reserve would squelch the bond market. "The Fed's announcement will likely signify the end of a great 30-year bull market in bonds and the necessity for bond managers and, yes, equity managers to adjust to a new environment," he said.

Gross said Treasury rates may be "rock bottom," but there are "safe spread" securities that are attractive. He and Grantham both see value in emerging markets, with Gross exposed to emerging market debt and Grantham moderately overweight in emerging market equities.

Grantham said he still sees compelling value in U.S. quality companies. "For good short-term momentum players, it may be heaven once again" as they are "so cheap," he said.

Gross said he also is exposed to high-quality global corporate bonds and U.S. agency mortgages, which are yielding 200 basis points "more than those 1 percent Treasuries. While our 'safe spread' terminology offers no guarantees, it is designed to let you sleep at night with less interest rate volatility."

COVER PHOTO: Chairman of the Federal Reserve Ben Bernanke testifies before the Joint Economic Committee on Capitol Hill in Washington April 14, 2010. **REUTERS/KEVIN LAMARQUE**

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