?I want to emphasize that growth of our balance sheet for reserve management purposes should in no way be confused with the large-scale asset purchase programs that we deployed after the financial crisis.? He then stated: ?***In no sense is this QE***.? ?Federal Reserve Chairman Jerome Powell 10/8/2019

Jerome Powell can call balance sheet growth whatever he wants, but operationally and in its effect on the bond markets, it is QE. For more on the Fed?s latest iteration of QE, what we dub the non-QE QE, please read our article *QE By Any Other Name*.

Non-QE = QE4

It is increasingly likely the Fed will announce an asset purchase operation at the FOMC meeting on October 30, 2019. Given Powell?s comments, the asset purchases will differ somewhat from QE 1, 2, and 3 in that the Fed will add *needed* reserves to the banking system to help alleviate recent bouts of stress in overnight funding markets. Prior versions of QE added *excess* reserves to the system as a byproduct. The true benefit of prior rounds of QE was the reduction of Treasury and mortgage-backed securities in the marketplace, which pushed investors into riskier stocks and bonds.

Since the Feds motivation seems to be stress in the short term funding markets, we believe the Fed will purchase short-term notes and Treasury bills instead of longer-term bonds. QE1 also involved the purchase the short term securities, but these securities were later sold and the proceeds used to purchase longer term bonds, in what was called Operation Twist.

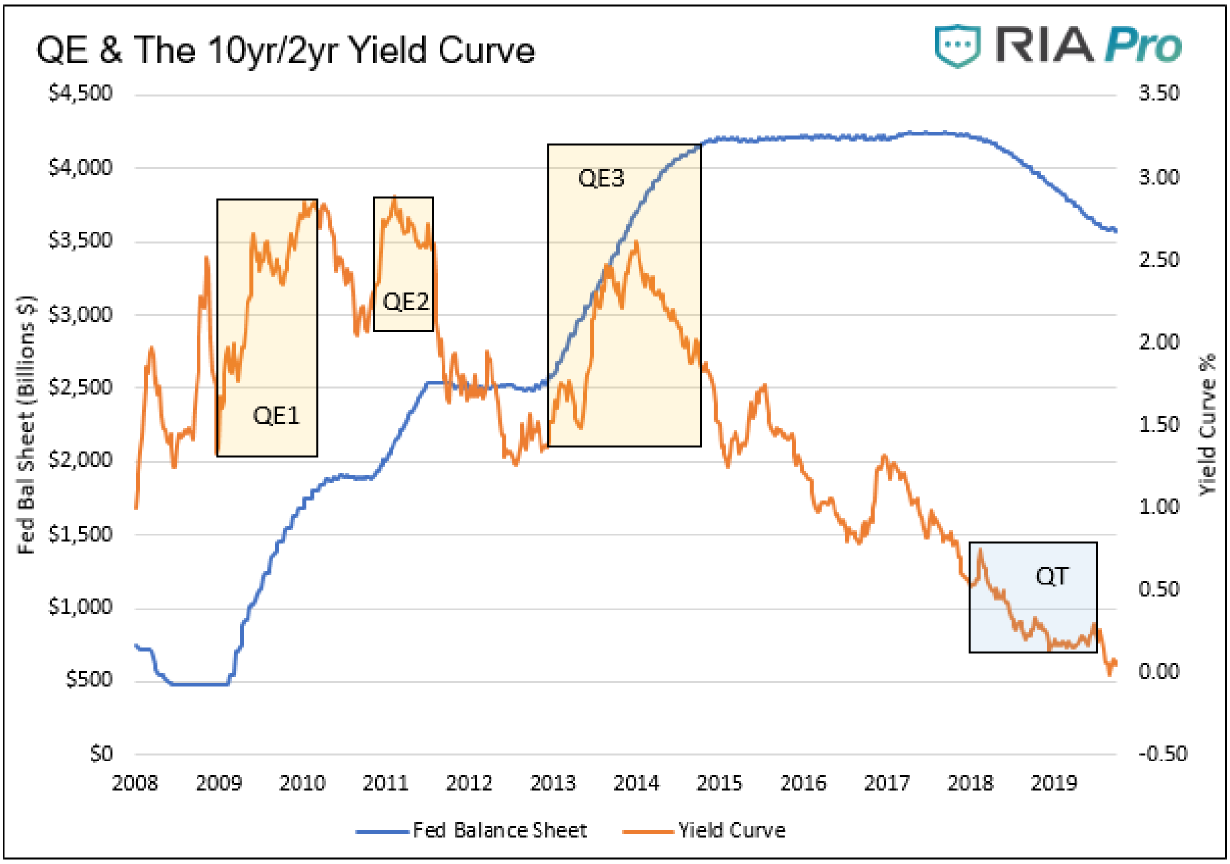
Trading Non QE QE4

In *Profiting From a Steepening Yield Curve* and in a subsequent *update* to the article, we presented two high dividend stocks (AGNC and NLY) that should benefit from a steeper yield curve. When we wrote the articles, we did not anticipate another round of QE, at least not this soon. Our premise behind these investments was weakening economic growth, the likelihood the Fed would cut rates aggressively, and thus a steepening yield curve as a result.

The Fed has since cut rates twice, and Wall Street expects them to cut another 25bps at the October 30th meeting and more in future meetings. This new round of proposed QE further bolsters our confidence in this trade.

If the Fed purchases shorter-term securities, the removal of at least $200 to $300 billion, as is being touted in the media, should push the front end of the curve lower in yield. Short end-based QE in conjunction with the Fed cutting rates will most certainly reduce front-end yields. The rate cuts combined with QE will likely prevent long term yields from falling as much as they would have otherwise. On balance, we expect the combination of QE and further rate cuts to result in a steeper yield curve.

The following graph shows how the 10yr/2yr Treasury yield curve steepened sharply after all three rounds of QE were initiated. In prior QE episodes, the yield curve steepened by 112 basis points on average to its peak steepness in each episode.



Data Courtesy: Federal Reserve

New Trade Idea

In addition to our current holdings (AGNC/NLY), we have a new recommendation involving a long/short bond ETF strategy. The correlation of performance and shape of the yield curve of this trade will likely be similar to the AGNC/NLY trade, but it should exhibit less volatility.

Equity long/short trades typically involve equal dollar purchases and sales of the respective securities, although sometimes they are also weighted by beta or volatility. Yield curve trades are similar in that they should be dollar-weighted, but they *must* also be weighted for the bond?s respective durations to account for volatility. This is because the price change of a two-year note is different than that of a 5 or 10-year note for the same change in yield, a concept called duration. Failing to properly duration weight a yield curve trade will not provide the expected gains and losses for given changes in the shape of the yield curve.

Before presenting the trade, it is important to note that the purest way to trade the yield curve is with Treasury bonds or Treasury bond futures. Once derivative instruments, like the ETFs we discuss, are introduced, other factors such as fees, dividends, and ETF rebalancing will affect performance.

The duration for SHY and IEF is 2.17 and 7.63, respectively. The ratio of the price of SHY to IEF is .74. The trade ratio of SHY shares to IEF shares is accordingly 4.75 as follows: [(1/.74)*(7.63/2.17)]. As such one who wishes to follow our guidance should buy 5 shares for every 1 share of IEF that they short.

Because we cannot buy fractions of shares, we rounded up the ratio to 5:1. This slight overweighting of SHY reflects our confidence that the short end of the yield curve will fall as the Fed operates as we expect.

Summary

In *Investors Are Grossly Underestimating the Fed*, we highlighted that every time the Fed has raised and lowered rates, the market has underestimated their actions. To wit:

?If the Fed initiates rate cuts and if the data in the graphs prove prescient, then current estimates for a Fed Funds rate of 1.50% to 1.75% in the spring of 2020 may be well above what we ultimately see. *Taking it a step further, it is not farfetched to think that that Fed Funds rate could be back at the zero-bound, or even negative, at some point sooner than anyone can fathom today.?*

Despite the Fed?s guidance earlier this year of one or two cuts and their characterization of it as a ?mid-cycle adjustment?, the Fed has already lowered rates twice and appears ready to cut rates a third time later this month. If, in fact, the market is once again underestimating the Fed, the Fed Funds rate and short term Treasury yields will ultimately fall to 1% or lower.

In an environment of QE and the Fed actively lowering rates, we suspect the yield curve will steepen. That is in no small part their objective, as a steeper yield curve also provides much needed aid to their constituents, the banks. If we are correct that the curve steepens, the long-short trade discussed above along with AGNC and NLY should perform admirably. AGNC and NLY are much more volatile than IEF and SHY; as such, this new recommendation is for more risk-averse traders.