FEDERAL RESERVE BANK of NEW YORK

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Minutes of the Investor Advisory Committee on Financial Markets

April 12, 2013

Federal Reserve Bank of New York

Committee attendees:

Nicole Arnaboldi, Credit Suisse Group
Louis Bacon, Moore Capital Mgmt
Mary Callahan-Erdoes, JP Morgan Asset Mgmt
Garth Friesen, III Associates
Joshua Harris, Apollo Management LP
Alan Howard, Brevan Howard Asset Management
Derek Kaufman, Citadel LLC
Michael Novogratz, Fortress Investment Group
Rick Rieder, BlackRock, Inc
Lawrence Schloss, NYC Public Pension Funds
Morgan Stark, Ramius Capital Group
David Tepper, Appaloosa Management LP

FRBNY attendees:

William Dudley, Chair
James Bergin
Terrence Checki
Christine Cumming
Jennifer Fortner
Steven Friedman
Krishna Guha
Karin Kimbrough
Sandy Krieger
Lorie Logan
Jamie McAndrews
Meg McConnell
Michael Nelson
Simon Potter
Kevin Stiroh

Overseas Developments

Members discussed the Bank of Japan's recent announcement of additional monetary policy easing, describing the measures as exceeding market expectations. Members characterized the response across Japanese and other global assets following the Bank of Japan's announcement as driven mainly by short-term foreign accounts. Focus remains on the extent to which domestic Japanese accounts might rebalance their portfolios. Uncertainties around the reaction function of Japanese investors, as well as structural and demographic factors weighing on the Japanese economic outlook, were cited as contributing to investor skepticism as to whether the recent policy initiatives will be sufficient for the Bank of Japan to meet their 2 percent price stability target within two years. There was also mention that the Bank of Japan's measures might raise the prospect of additional easing by other global central banks.

The Committee then turned to a discussion of Europe. Although members were attentive to developments in Cyprus and Italian political uncertainty, the events were seen as having limited impact on global asset prices thus far. Members noted the ECB's OMT as continuing to be viewed as reducing tail risk scenarios in Europe. Members discussed potential negative market impacts of the proposed European financial transactions tax, particularly risks to repo markets. Ongoing weakness in the European economic outlook and undercapitalization of European banks compared to their global peers were also mentioned as ongoing risks.

Domestic Policy

The Committee next discussed the U.S. economic outlook, characterizing the economy as thus far fairly resilient to fiscal contraction and noting ongoing strength in the housing market, though employment growth remains modest. On the topic of U.S. monetary policy, members noted that many market participants expect the FOMC to eventually adjust the pace of purchases, with focus on changes to the unemployment rate as one factor informing potential changes to monthly purchase pace. Members also discussed the possibility that the FOMC might change its exit principles to hold assets for a longer period without selling. A lengthening of the time horizon to asset sales was considered by members as adding additional accommodation. Separately, members noted that market indicators currently price in little risk associated with an earlier- or faster-than-expected tightening by the FOMC.

Financial Landscape

The meeting concluded with a discussion of the current state of investor positioning for a potential rise in interest rates. The business model of agency REITs was viewed as vulnerable to any sharp rise in rates, given relatively high leverage and perceived duration mismatch between assets and liabilities. Regional banks were also cited as having some sensitivity to losses in the case of a sharp rise in rates, particularly as banks have added higher-yielding assets to their portfolios in the low rate environment. Finally, members discussed risks associated with the potential reaction of retail investors to a sharp rise in rates. Note was made of the larger footprint of retail accounts in credit markets given rising allocations to fixed income instruments over recent years. Uncertainty was expressed as to the potential market functioning impacts of large outflows from corporate credit-related mutual funds and ETFs, especially as retail holdings of corporate bonds have increased relative to market volumes and broker-dealer balances have decreased.