FEDERAL RESERVE BANK of NEW YORK

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Minutes of the Investor Advisory Committee on Financial Markets

January 15, 2013

Federal Reserve Bank of New York

Committee attendees:

Nicole Arnaboldi, Credit Suisse Group
Louis Bacon, Moore Capital Mgmt
James Chanos, Kynikos Associates
Mary Callahan-Erdoes, JP Morgan Asset Mgmt
Garth Friesen, III Associates
Joshua Harris, Apollo Management LP
Alan Howard, Brevan Howard Asset Management
Scott Malpass, University of Notre Dame
Deryck Maughan, KKR
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
Tobias Adrian
James Bergin
Terrence Checki
Christine Cumming
Jennifer Fortner
Steven Friedman
Krishna Guha
Joyce Hansen
Karin Kimbrough
Sandy Krieger
Lorie Logan
Meg McConnell
Simon Potter
Kevin Stiroh

Monetary Policy

The meeting commenced with a discussion of monetary policy developments. Members described ongoing accommodation by global central banks as contributing to an environment of low yields on fixed income assets and supporting investor allocations to higher yielding credit and equity assets. In the U.S., limited net issuance of fixed income securities, especially when accounting for Federal Reserve purchases, supports ongoing tightening of credit spreads.

The FOMC's introduction of unemployment and inflation thresholds to the forward rate guidance was characterized as enhancing the FOMC's ability to respond to the evolution of economic data. Members noted the possibility for some increased volatility in monetary policy expectations when unemployment and/or inflation measures approach the stated thresholds, stating that FOMC communication will remain important in guiding market expectations around the thresholds.

Committee members discussed the current dynamics of cyclical versus structural unemployment. Factors such as skills mismatch, extended periods of unemployment amongst the younger working age population, older workers remaining in the labor force for longer periods, and the rising cost to businesses of healthcare and pensions were mentioned as contributing to friction in declining unemployment rates.

Financial Landscape

The Committee next turned to the current state of volatility-related financial products. Over the past several years products that pay-off in the case of increasing U.S. equity market volatility have performed relatively poorly, as volatility has fallen on net. Tail risk hedge funds, whose strategies involve providing insurance against highly negative moves in financial asset prices, have also shown a wide dispersion in returns. Structured notes, which provide exposure to equity market increases while mitigating some downside risk, have also garnered some retail investor interest though note was made of the small size of this market in the U.S.

Outlook

The meeting concluded with a roundtable discussion of some of the main upside and downside risks to the global economy in the year ahead. Members discussed potential market volatility around the U.S. debt ceiling and the possibility that fiscal adjustments might put downward pressure on U.S. economic growth. Weak state and local government finances were also discussed. Smooth resolution of the debt ceiling debate and policies that improve the longer-term outlook for U.S. finances were mentioned as an upside risk. Separately, some members noted risks to certain investor classes around the potential for rising yields in fixed income products. On a longer horizon, investors have begun to consider potential risks around the FOMC's exit from accommodative monetary policy.

Focus was also on ongoing risks surrounding Europe, particularly the potential for a continued weak economic growth outlook in peripheral economies to prompt renewed domestic political and social tensions. A slowdown in emerging market growth, particularly China, likewise remains a risk. Concerns also remain around any stress in China's banking sector associated with non-performing loans and increasing disintermediation in lending. In Japan, members noted some potential for market volatility should policy measures prompt a large reallocation of assets held by Japanese investors.