Monetary Policy

The Impact on GDP, Employment, and Inflation

May 30, 2014

Today's interest rate environment is extremely low by historical standards. Figure 1 illustrates this fact by comparing the average term structure (yield curve) over the three time periods:

1. Normalized period: between 1990 and 2007,
2. The crisis: Q4 2007 to Q2 2009 and,
3. Since the end of the crisis: Q3 2009 to Q1 2014.

Current long-term yields are roughly 54% lower relative to historical norms, while short-term yields are lower by whooping 91%. This also points to the fact that current term structure is also steep relative to historical standards. The spread between 2 year and 10 year UST is approximately 215bps, much higher than the 93bps witnessed between 1990 and 2007. The reason for the exceptionally low yields and the steepness of the curve is the Fed's extremely accommodative monetary policy; initially represented by reduction in Fed Fund Rates, Quantitative Easing (bond buying), and most recently, its Forward Guidance.

The low interest rate environment has not resulted in significant economic improvements that the Fed and the Markets expected given the amount and duration of policy accommodation. The recovery has been slow and rather sluggish, as illustrated by lackluster GDP numbers (Figure 2). The nominal 2.2% GDP growth rate observed since Q3 2009 is lower than the long-term levels. Many economists have questioned the efficacy of the Fed's aggressive monetary policy accomodation and the results given tepid grwoth in the economy.

Figure 1: Treasury Yields

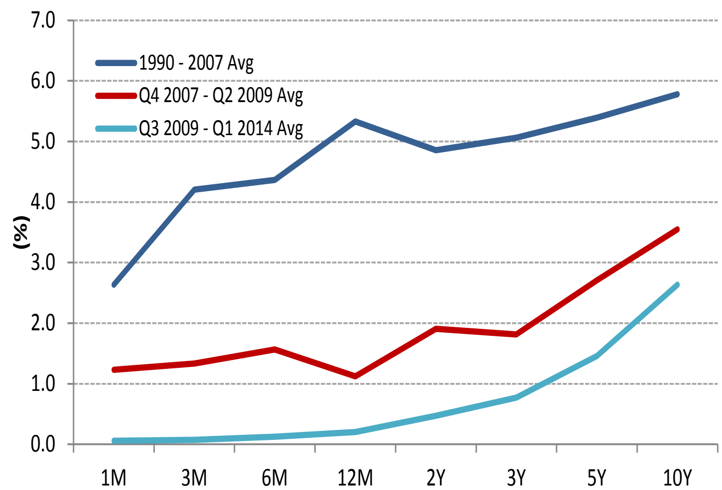
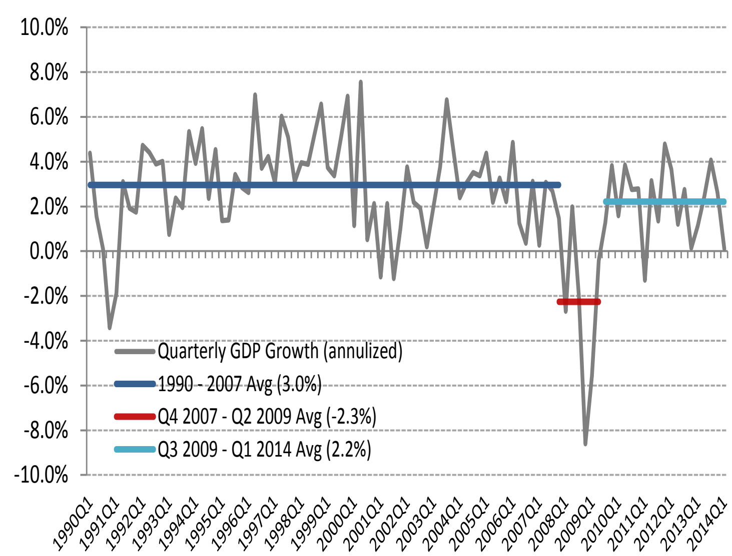


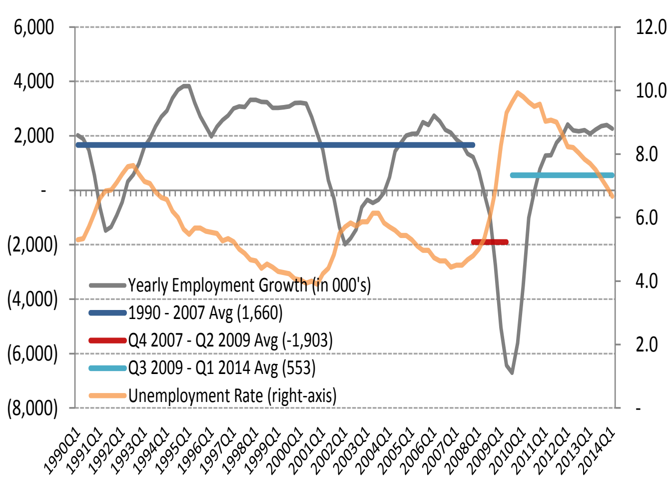
Figure 2: GDP Growth



Despite the aggressive monetary policy, inflation remains well below Fed's target rate of 2% (Figure 3). In fact, the recent observation of inflation, as measured by PCE, has been stuck at the 1% level since early 2013. The low rate of core inflation can be partially explained by the complete collapse in the velocity of money (M2), as illustrated in Figure 4, reflecting tight lending standards by banks. Without the expansion of credit and leverage in the economy, M2 will remain well below its historical mean and resulting in continued low inflation.

Lastly, the employment situation has improved since the crisis (Figure 5), but is still below the long-term trend levels. Furthermore, wage growth has continued to be stagnant and downward wage pressures continue as the long-term unemployed slowly seek to return to the job market. Total unemployed as measured by U6 measure by the Bureau of Labor Statistics (Figure 6) continues to indicate slack in the labor markets that is not being absorbed by the current underlying growth rate of the economy. The U6 unemployment rate counts not only people without work seeking full-time employment, but also includes "marginally attached workers and those working part-time for economic reasons."

Figure 5: Employment Growth



Unemployment Rate Averages
1990-2007: 5.4%
2007Q4-2009Q2: 6.5%
2009Q3-2014Q1: 8.5%

Sources for Graphs:

Bloomberg, US Bureau of Economic Analysis, US Bureau of Labor Statistics, FBC

Figure 3: PCE Inflation

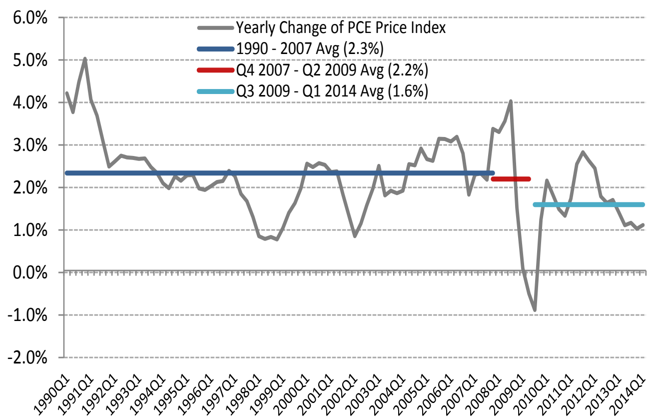


Figure 4: Money Multipliers

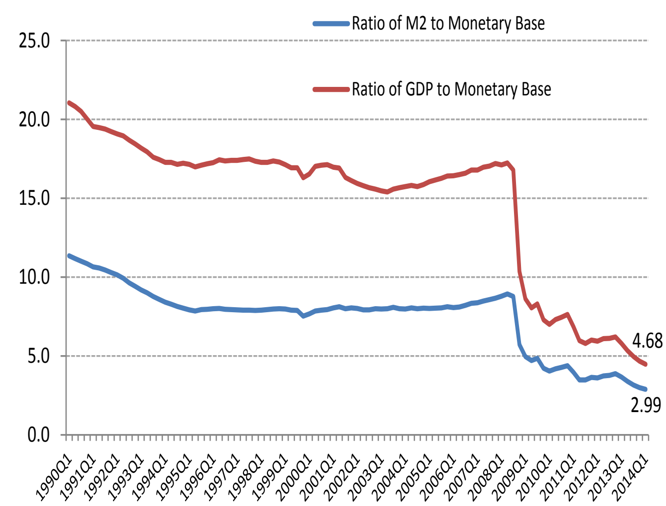
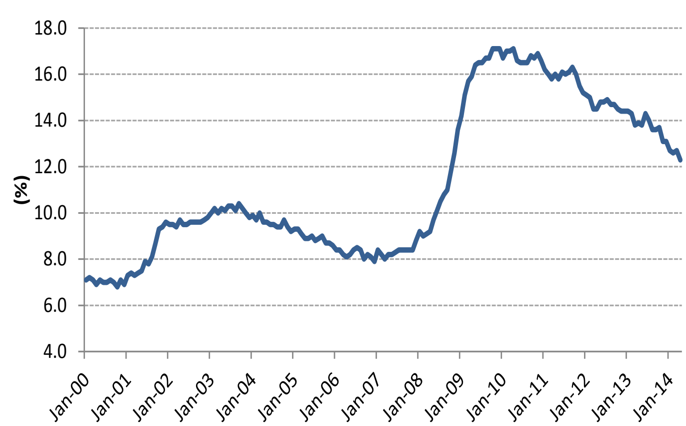


Figure 6: U6 - Unemployment Rate



Conclusion:

It has taken the Federal Reserve an unprecedented degree of monetary easing to achieve only modest improvement in the U.S. economy. It is unlikely that in its current state, the economy can withstand higher interest rates or reversion to the long-term mean. **In fact, the recent rally in the bond market has clearly indicated fundamental weakness in the economy may persist for a long period of time, and will require continued policy accommodation, as has also been communicated by the Fed on numerous occasions.**

Disclosures

For questions or additional information, please contact:

Aga Brazil	Sunil Chowdry, CFA
abrazil@falconbridgecapital.com	schowdry@falconbridgecapital.com
(925) 979-4291	(925) 979-4280

- BY ACCEPTING A COPY OF THIS CONFIDENTIAL PRESENTATION, THE RECIPIENT AGREES THAT NEITHER IT NOR ANY OF ITS EMPLOYEES OR ADVISORS SHALL USE THE INFORMATION FOR ANY PURPOSE OTHER THAN EVALUATING THE SPECIFIC TRANSACTION DESCRIBED HEREIN OR DIVULGE TO ANY OTHER PARTY SUCH INFORMATION. THIS CONFIDENTIAL PRESENTATION SHALL NOT BE PHOTOCOPIED, REPRODUCED OR DISTRIBUTED TO OTHERS WITHOUT THE PRIOR WRITTEN CONSENT OF THE PRINCIPALS.
- NOTWITHSTANDING ANYTHING TO THE CONTRARY CONTAINED HEREIN, THE RECIPIENT (AND EACH EMPLOYEE, REPRESENTATIVE, OR OTHER AGENT OF THE RECIPIENT) MAY DISCLOSE TO ANY AND ALL PERSONS, WITHOUT LIMITATION OF ANY KIND, THE TAX TREATMENT AND TAX STRUCTURE OF THE TRANSACTIONS DESCRIBED HEREIN) AND ALL MATERIALS OF ANY KIND THAT ARE PROVIDED TO THE PROSPECTIVE INVESTOR RELATING TO SUCH TAX TREATMENT AND TAX STRUCTURE (AS SUCH TERMS ARE DEFINED IN TREASURY REGULATION SECTION 1.6011-4). THIS AUTHORIZATION OF TAX DISCLOSURE IS RETROACTIVELY EFFECTIVE TO THE COMMENCEMENT OF DISCUSSIONS WITH PROSPECTIVE INVESTORS REGARDING THE TRANSACTIONS CONTEMPLATED HEREIN.
- THE FINANCIAL PROJECTIONS INCLUDED HEREIN HAVE BEEN PREPARED ON THE BASIS OF ASSUMPTIONS STATED THEREIN. FUTURE OPERATING RESULTS ARE IMPOSSIBLE TO PREDICT AND NO REPRESENTATION OF ANY KIND IS MADE RESPECTING THE FUTURE ACCURACY OR COMPLETENESS OF THESE FORECASTS.
- THIS DOCUMENT AND THE RELATED ORAL PRESENTATION IS NOT AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY SECURITIES.
- THE INFORMATION INCLUDED HEREIN IS PRELIMINARY, AND WILL BE SUPERSEDED BY A DEFINITIVE PRIVATE PLACEMENT MEMORANDUM.
- WE WILL NOT ACCEPT ANY OFFER BY YOU TO PURCHASE SECURITIES AND YOU WILL NOT HAVE ANY CONTRACTUAL COMMITMENT TO PURCHASE SECURITIES UNTIL AFTER YOU HAVE RECEIVED THE DEFINITIVE PRIVATE PLACEMENT MEMORANDUM.
- DISCUSSIONS OF FEDERAL TAX ISSUES IN THIS PRESENTATION ARE NOT INTENDED TO BE RELIED UPON BY INDIVIDUAL INVESTORS. EACH INVESTOR SHOULD SEEK ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.
- THERE CAN BE NO ASSURANCE THAT PROJECTED RETURNS WILL BE ACHIEVED OR THAT THE FUND WILL BE ABLE TO IMPLEMENT ITS INVESTMENT STRATEGY OR ACHIEVE ITS INVESTMENT OBJECTIVES.
- GROSS IRRs DO NOT REFLECT MANAGEMENT FEES, CARRIED INTEREST, TAXES, TRANSACTION COSTS AND OTHER EXPENSES TO BE BORNE BY INVESTORS IN THE FUNDS, WHICH WILL REDUCE RETURNS.