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# FED MINUTES: JUSTIFY RATE INCREASE, CHANGE TO ITS REINVESTMENT POLICY SOON

The minutes of the FOMC's March 15th meeting provided support for its decision to raise its Federal funds rate but importantly revealed an extensive discussion of the steps the Fed is considering to begin reducing the size of its balance sheet. The Fed's portfolio has a massive $4.5 trillion in assets. With signs of the economy improving and inflation at the Fed's long-run target, and with the normalization of interest rates already well underway, addressing the Fed's balance sheet is long overdue. This was the focus of Mickey's testimony to the House Financial Services Committee yesterday (see "Testimony to House Financial Services Committee", April 4, 2017).

***The Fed minutes revealed that "most participants anticipated…that a change to the Committee's reinvestment policy would likely be appropriate later this year." Based*** *on the anticipated pickup in economic growth, drift up in inflation and tight labor markets and rising wages, we now expect the Fed to raise rates in June and September, rather than September and December. Because the Fed is likely to modify its reinvestment policy, we continue to expect only two more rate increases in 2017, for a total of 3 rate increases during the year. However, we now project four hikes in 2018, compared to three previously). This reflects in part our continued expectation that some form of tax and fiscal reform legislation will be enacted. This would imply the Fed funds rate at 1.25%-1.5% at year-end 2017 and 2.25-2.5% at year-end 2018* (see updated outlook table below).

The strong employment, buoyant confidence data and pickup in the US and global economies, along with inflation risks, suggest that three additional rate hikes in 2017 are possible, but in light of the Fed's intention to modify its reinvestment policy that would lead to a decline in its balance sheet, we expect the Fed to pause in its interest rate increases to see how markets and the economy absorb its balance sheet normalization. President of the New York Fed Bill Dudley, in a recent Bloomberg interview stated that, "If we start to normalize the balance sheet, that's a substitute for short-term rate hikes," and "we might actually decide at the same time to take a little pause in terms of raising short-term interest rates."

We note that with the economy growing and financial markets functioning normally, **the Fed's excessively large portfolio of Treasuries ($2.5 trillion) and mortgage backed** securities ($1.8 trillion) serves no economic purpose but involves significant interest rate risk and inappropriately involves monetary policy in credit allocation.

In discussing when to change its reinvestment policy, several FOMC participants discussed possibly setting a quantitative threshold linked to the federal funds rate while others thought the start should be qualitative and dependent on the economic outlook. The Committee should establish a strategy that materially but gradually and predictably reduces its balance sheet that involves the least uncertainty, and sticking to that strategy, rather than modifying it in response to every ripple in financial markets and high-frequency economic data. The Fed should learn from its befuddling and evolving use of quantitative triggers and calendar-based methods in ending QEIII and beginning to normalize interest rates, which served only to delay the process.

The Committee is undecided as to whether or not to phase out or cease reinvestments, and cited cons and pros of both. It plans to apply the change in its reinvestment policy to both Treasury securities and agency MBS. Its difficulty in implementing the down-sizing of its portfolio is that nearly all of its MBS holdings are long-dated maturities while a fair chunk of its Treasury holdings are due to mature in the next handful of

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Mickey D. Levy
Chief Economist US, Americas and Asia
+1 646 445 4842
mickey.levy@berenberg-us.com

Roiana Reid
Economist
+1 646 445 4865
roiana.reid@berenberg-us.com

years, and that it would like to reduce the size of its balance sheet through passive runoff of maturing assets rather than outright sales (see Charts 1 and 2). Eventually, we expect the Fed will have to take a more aggressive approach in reducing the size of its MBS holdings through sales. **These tradeoffs and the Fed's sensitivity to market responses make for a difficult** Fed decision.

**The Fed's decision on the amount of targeted runoff will be heavily influenced by its perception of the market reaction to** its decision. We expect the economy and housing activity to continue to improve, and inflation to drift up. In this context, we expect the Fed will view the option of taking steps to reduce its balance sheet as a favorable substitute to raising rates faster.

If the Fe**d clearly communicates its plans, financial markets will adjust to the Fed's portfolio unwind strategy, and economic** performance will actually improve.

**Note that the minutes showed an unusual discussion of financial asset valuations: "Some participants vie**wed equity prices as quite high relative to standard valuation measures. It was observed that prices of other risk assets, such as emerging market stocks, high-yield corporate bonds, and commercial real estate, had also risen significantly in recent months**."**

**This suggests that the Fed could also be putting its macro prudential "hat" on in the near**-to-medium term and as such, could have more reason to tighten policy at a faster-than-expect pace in coming years.

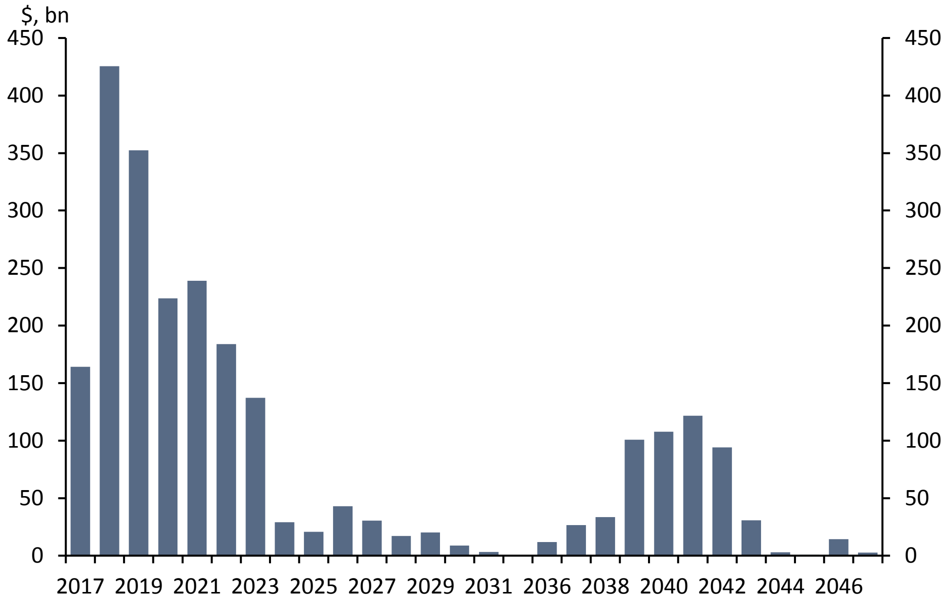
After years of sluggish movement by the Fed, **it is finally on the normalization train. Let's just hope that it's not too late.**

Table 1: US economic outlook table

| | | 2015 | 2016 | 2017 | 2018 | 1Q16 | 2Q16 | 3Q16 | 4Q16 | 1Q17 | 2Q17 | 3Q17 | 4Q17 | 1Q18 | 2Q18 | 3Q18 | 4Q18 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP | % y/y | 2.6 | 1.6 | 2.4 | 2.9 | 1.6 | 1.3 | 1.7 | 2.0 | 2.1 | 2.5 | 2.4 | 2.6 | 3.0 | 2.9 | 2.9 | 2.9 |
| | % q/q | | | | | 0.2 | 0.4 | 0.9 | 0.5 | 0.3 | 0.8 | 0.7 | 0.7 | 0.8 | 0.7 | 0.7 | 0.7 |
| | %q/q ann. | | | | | 0.8 | 1.4 | 3.5 | 2.1 | 1.3 | 3.1 | 3.0 | 3.0 | 3.1 | 2.7 | 2.8 | 2.9 |
| Private Consumption | % y/y | 3.2 | 2.7 | 2.7 | 2.7 | 2.4 | 2.7 | 2.8 | 3.1 | 3.0 | 2.7 | 2.6 | 2.4 | 2.8 | 2.7 | 2.7 | 2.6 |
| | % q/q | | | | | 0.4 | 1.1 | 0.7 | 0.9 | 0.3 | 0.7 | 0.7 | 0.7 | 0.7 | 0.6 | 0.6 | 0.6 |
| Residential Investment | % y/y | 11.7 | 4.9 | 4.2 | 5.0 | 11.7 | 5.7 | 1.5 | 1.1 | 1.1 | 4.4 | 6.2 | 5.1 | 4.4 | 4.6 | 5.3 | 5.6 |
| | % q/q | | | | | 1.9 | -2.0 | -1.1 | 2.3 | 1.9 | 1.1 | 0.7 | 1.2 | 1.3 | 1.3 | 1.4 | 1.5 |
| Non-Residential Investment | % y/y | 2.1 | -0.5 | 4.4 | 6.5 | -0.4 | -0.5 | -1.1 | -0.1 | 2.5 | 3.6 | 4.9 | 6.4 | 6.3 | 6.5 | 6.5 | 6.6 |
| | % q/q | | | | | -0.9 | 0.2 | 0.3 | 0.2 | 1.7 | 1.4 | 1.6 | 1.6 | 1.6 | 1.6 | 1.7 | 1.7 |
| Government Spending | % y/y | 1.8 | 0.8 | 0.3 | 2.6 | 1.9 | 0.7 | 0.4 | 0.2 | -0.5 | 0.4 | 0.5 | 0.9 | 2.0 | 2.3 | 2.8 | 3.2 |
| | % q/q | | | | | 0.4 | -0.4 | 0.2 | 0.0 | -0.3 | 0.5 | 0.3 | 0.4 | 0.8 | 0.8 | 0.8 | 0.8 |
| Final Dom Demand [1] | % y/y | 3.1 | 2.1 | 2.5 | 3.2 | 2.2 | 2.0 | 1.8 | 2.1 | 2.3 | 2.5 | 2.7 | 2.7 | 3.2 | 3.2 | 3.3 | 3.3 |
| | % q/q | | | | | 0.3 | 0.6 | 0.5 | 0.7 | 0.5 | 0.8 | 0.7 | 0.8 | 0.9 | 0.8 | 0.8 | 0.8 |
| Net Exports [1] | % y/y | -0.7 | -0.1 | -0.4 | -0.4 | -0.3 | -0.2 | 0.2 | -0.2 | -0.4 | -0.4 | -0.6 | -0.2 | -0.2 | -0.4 | -0.5 | -0.5 |
| | % q/q | | | | | 0.0 | 0.0 | 0.2 | -0.5 | -0.1 | 0.0 | 0.0 | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 |
| Stockbuilding [1, 5] | % y/y | 0.2 | -0.4 | 0.1 | 0.0 | -0.1 | -0.3 | 0.1 | 0.3 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Nominal GDP | % y/y | 3.7 | 3.0 | 5.0 | 5.4 | 2.8 | 2.5 | 2.9 | 3.8 | 4.8 | 5.1 | 4.9 | 5.2 | 5.5 | 5.5 | 5.4 | 5.3 |
| Current Account Balance | USD bn | -463 | -503 | -560 | -622 | -133 | -120 | -116 | -134 | -139 | -140 | -140 | -142 | -147 | -153 | -158 | -163 |
| | % of GDP | -2.6 | -2.7 | -2.9 | -3.0 | -2.9 | -2.6 | -2.5 | -2.8 | -2.9 | -2.9 | -2.8 | -2.9 | -2.9 | -3.0 | -3.1 | -3.1 |
| Industrial Production [2] | % y/y | 0.3 | -1.0 | 1.6 | 3.1 | -1.6 | -1.1 | -1.1 | -0.1 | 0.6 | 1.4 | 1.9 | 2.6 | 3.2 | 3.4 | 3.1 | 2.9 |
| | % q/q | | | | | -0.4 | -0.2 | 0.4 | 0.1 | 0.3 | 0.5 | 1.0 | 0.7 | 0.9 | 0.7 | 0.6 | 0.6 |
| Unemployment Rate [2] | % | 5.3 | 4.9 | 4.6 | 4.5 | 4.9 | 4.9 | 4.9 | 4.7 | 4.7 | 4.6 | 4.6 | 4.5 | 4.5 | 4.5 | 4.5 | 4.4 |
| CPI [2] | % y/y | 0.1 | 1.3 | 2.6 | 2.4 | 1.1 | 1.1 | 1.1 | 1.8 | 2.7 | 2.5 | 2.5 | 2.6 | 2.4 | 2.5 | 2.5 | 2.4 |
| Core PCE [2] | % y/y | 1.4 | 1.7 | 1.8 | 2.0 | 1.6 | 1.6 | 1.7 | 1.7 | 1.7 | 1.8 | 1.8 | 1.8 | 1.9 | 1.9 | 2.0 | 2.1 |
| Federal Govt. Balance [3,6] | % of GDP | -2.4 | -3.0 | -3.2 | -3.6 | | | | | | | | | | | | |
| General Govt. Debt | % of GDP | 101.5 | 101.6 | 99.9 | 98.4 | | | | | | | | | | | | |
| Fed Funds Rate [4] | % | 0.50 | 0.75 | 1.50 | 2.50 | 0.50 | 0.50 | 0.50 | 0.75 | 1.00 | 1.25 | 1.50 | 1.50 | 1.75 | 2.00 | 2.25 | 2.50 |

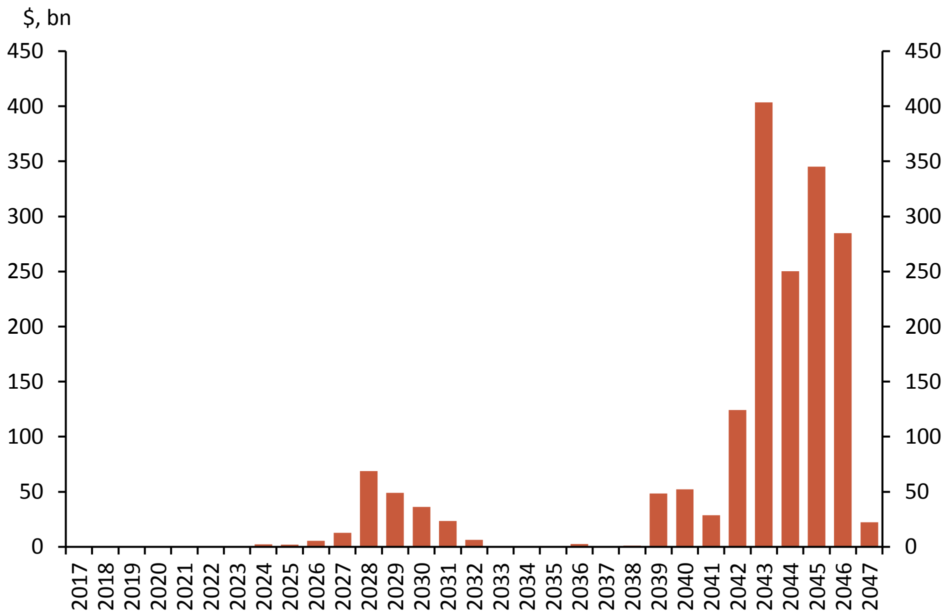
*1 Contribution to GDP growth 2 Period averages 3 Federal budget balance 4 End of period*
*5 Annual data refers to yoy change and quarterly data refers to qoq change*
*6 Differs from Maastricht definition used for European countries. Under Maastricht, the balance would be -4.4% in 2015 and -4.6% in 2016 (EU Commission)*

Chart 1: Maturity of Fed Holdings of US Treasury Securities




*Source: Federal Reserve and Berenberg Capital Markets*

Chart 2: Maturity of Fed Holdings of MBS*




**Note: Assumes no amortization. Source: Federal Reserve and Berenberg Capital Markets*

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# Contacts: BCM

www.berenberg.com
e-mail US: firstname.lastname@berenberg-us.com

## JOH. BERENBERG, GOSSLER & CO. KG

Internet www.berenberg.com
E-mail: firstname.lastname@berenberg.com

### EQUITY RESEARCH

**AEROSPACE & DEFENCE**
Andrew Gollan +44 20 3207 7891
Charlotte Keyworth +44 20 3753 3013
Ross Law +44 20 3465 2692

**AUTOMOTIVES**
Adam Hull +44 20 3465 2749
Paul Kratz +44 20 3465 2678

**BANKS**
Adam Barrass +44 20 3207 7923
James Chappell +44 20 3207 7844
Andrew Lowe +44 20 3465 2743
Andreas Markou (EM) +44 20 3753 3022
Eoin Mullany +44 20 3207 7854
Peter Richardson +44 20 3465 2681
Jonathan Sharpe +44 20 3753 3031

**BEVERAGES**
Javier Gonzalez Lastra +44 20 3465 2719
Batuhan Karabekir (EM) +44 20 3465 2631
Adam Mizrahi +44 20 3465 2653

**BUSINESS SERVICES, LEISURE & TRANSPORT**
Roberta Ciaccia +44 20 3207 7805
Najet El Kassir +44 20 3207 7836
Stuart Gordon +44 20 3207 7858
Josh Puddle +44 20 3207 7881
Julia Winarso +44 20 3465 2627

**CAPITAL GOODS**
Sebastian Kuenne +44 20 3207 7856
Philippe Lorrain +44 20 3207 7823
Rizk Maidi +44 20 3207 7806
Horace Tam +44 20 3465 2726
Simon Toennessen +44 20 3207 7819

**CHEMICALS**
Sebastian Bray +44 20 3753 3011
Andrew Heap +44 20 3207 7918

**CONSTRUCTION**
Lush Mahendrarajah +44 20 3207 7896
Robert Muir +44 20 3207 7860
Olivia Peters +44 20 3465 2646

**ENERGY**
Yuriy Kukhtanych (EM) +44 20 3465 2675

**FOOD MANUFACTURING AND H&PC**
Rosie Edwards +44 20 3207 7880
Yordana Mavrodieva +44 20 3207 7817
Fintan Ryan +44 20 3465 2748
James Targett +44 20 3207 7873

**FOOD RETAIL**
Batuhan Karabekir (EM) +44 20 3465 2631

**GENERAL MID CAP - EU**
Gunnar Cohrs +44 20 3207 7894
Martin Comtesse +44 20 3207 7878
Flavien Hias +44 20 3465 2693
Aymeric Lang +44 20 3753 3037
Anna Patrice +44 20 3207 7863
Benjamin Pfannes-Varrow +44 20 3465 2620
Simona Sarli +44 20 3207 7834
Julia Scheufler +44 20 3753 3016

**GENERAL MID CAP - UK**
Robert Chantry +44 20 3207 7861
Sam England +44 20 3465 2687
Ned Hammond +44 20 3753 3017
Benjamin May +44 20 3465 2667
Owen Shirley +44 20 3465 2731

**GENERAL RETAIL**
Conrad Bartos +44 20 3753 3053
Michelle Wilson +44 20 3465 2663

**HEALTHCARE**
Scott Bardo +44 20 3207 7869
Jakob Berry +44 20 3465 2724
Alistair Campbell +44 20 3207 7876
Graham Doyle +44 20 3465 2634
Klara Fernandes +44 20 3465 2718
Tom Jones +44 20 3207 7877
Joseph Lockey +44 20 3465 2730
Louise Pearson +44 20 3465 2747
Laura Sutcliffe +44 20 3465 2669

**INSURANCE**
Trevor Moss +44 20 3207 7893
Emanuele Musio +44 20 3207 7916
Iain Pearce +44 20 3465 2665
Sami Taipalus +44 20 3207 7866

**LUXURY GOODS**
Zuzanna Pusz +44 20 3207 7812

**MEDIA**
Robert Berg +44 20 3465 2680
Laura Janssens +44 20 3465 2639
Alastair Reid +44 20 3207 7841
Sarah Simon +44 20 3207 7830

**METALS & MINING**
Alessandro Abate +44 20 3753 3029
Fawzi Hanano +44 20 3207 7910
Yuriy Vlasov +44 20 3465 2674

**REAL ESTATE**
Kai Klose +44 20 3207 7888
Tina Munda +44 20 3465 2716

**TECHNOLOGY**
Jean Beaubois +44 20 3207 7835
Georgios Kertsos +44 20 3465 2715
Gal Munda +44 20 3465 2746
Tammy Qiu +44 20 3465 2673

**TELECOMMUNICATIONS**
Ondrej Cabejsek (EM) +44 20 3753 3071
Usman Ghazi +44 20 3207 7824
Siyi He +44 20 3465 2697
Laura Janssens +44 20 3465 2639
Paul Marsch +44 20 3207 7857
Michael Summerville +44 20 3207 7914

**THEMATIC RESEARCH**
Nick Anderson +44 20 3207 7838
Asad Farid +44 20 3207 7932

**TOBACCO**
Jonathan Leinster +44 20 3465 2645

**UTILITIES**
Robin Abrams +44 20 3465 2635
Andrew Fisher +44 20 3207 7937
Lawson Steele +44 20 3207 7887

### ECONOMICS
Florian Hense +44 20 3207 7859
Carsten Hesse (EM) +44 20 3753 3001
Kallum Pickering +44 20 3465 2672
Holger Schmieding +44 20 3207 7889

### EQUITY SALES

#### SPECIALIST SALES
**AEROSPACE & DEFENCE**
Bruna Zugliani +44 20 3207 7818
**AUTOMOTIVE & THEMATICS**
Chris Armstrong +44 20 3207 7809
**BANKS & DIVERSIFIED FINANCIALS**
Iro Papadopoulou +44 20 3207 7924
**BUSINESS SERVICES, LEISURE & TRANSPORT**
Rebecca Langley +44 20 3207 7930
**CONSTRUCTION,CHEMICALS, METALS & MINING**
James Williamson +44 20 3207 7842
**CONSUMER STAPLES**
Rupert Trotter +44 20 3207 7815
**CONSUMER DISCRETIONARY**
Victoria Maigrot +44 20 3753 3010
**HEALTHCARE**
Frazer Hall +44 20 3207 7875
**MEDIA & TELECOMMUNICATIONS**
Julia Thannheiser +44 20 3465 2676
**SPECIAL SITUATIONS**
Jeremy Grant +44 20 3207 7890

#### SALES
**BENELUX**
Miel Bakker +44 20 3207 7808
Martin de Laet +44 20 3207 7804
Alexander Wace +44 20 3465 2670

**GERMANY**
Michael Brauburger +49 69 91 30 90 741
Nina Buechs +49 69 91 30 90 735
André Grosskurth +49 69 91 30 90 734

**GERMANY (cont'd)**
Florian Peter +49 69 91 30 90 740
Joerg Wenzel +49 69 91 30 90 743

**UK**
Alexandra Clément +44 20 3753 3018
Fabian De Smet +44 20 3207 7810
Karl Hancock +44 20 3207 7803
Sean Heath +44 20 3465 2742
David Hogg +44 20 3465 2628
Peter Kaineder +44 20 3753 3062
James Matthews +44 20 3207 7807
David Mortlock +44 20 3207 7850
Eleni Papoula +44 20 3465 2741
Bhavin Patel +44 20 3207 7926
Richard Payman +44 20 3207 7825
Joanna Sanders +44 20 3207 7925
Mark Sheridan +44 20 3207 7802
George Smibert +44 20 3207 7911
Anita Surana +44 20 3207 7855
Paul Walker +44 20 3465 2632

**FRANCE**
Thibault Bourgeat +33 1 5844 9505
Alexandre Chevassus +33 1 5844 9512
Dalila Farigoule +33 1 5844 9510
Clémence Peyraud +33 1 5844 9521
Benjamin Voisin +33 1 5844 9507

**SCANDINAVIA**
Frederik Angel +44 20 3753 3055
Marco Weiss +49 40 350 60 719

**SWITZERLAND, AUSTRIA & ITALY**
Andrea Ferrari +41 44 283 2020
Carsten Kinder +41 44 283 2024
Gianni Lavigna +41 44 283 2038
Jamie Nettleton +41 44 283 2026
Benjamin Stillfried +41 44 283 2033

#### CRM
Louise Hughes +44 20 3753 3066
Jessica Jarmyn +44 20 3465 2696
Edwina Lucas +44 20 3207 7908
Greg Swallow +44 20 3207 7833

#### CORPORATE ACCESS
Lindsay Arnold +44 20 3207 7821
Jennie Jiricny +44 20 3207 7886
Stella Siggins +44 20 3465 2630

#### EVENTS
Laura Hawes +44 20 3753 3008
Suzy Khan +44 20 3207 7915
Charlotte Kilby +44 20 3207 7832
Natalie Meech +44 20 3207 7831
Ellen Parker +44 20 3465 2684
Sarah Weyman +44 20 3207 7801

### SALES TRADING
**HAMBURG**
Tim Storm +49 40 350 60 415

**PARIS**
Vincent Klein +33 1 58 44 95 09
Antonio Scuotto +33 1 58 44 95 03

**LONDON**
Mike Berry +44 20 3465 2755
Stewart Cook +44 20 3465 2752
Mark Edwards +44 20 3753 3004
Tristan Hedley +44 20 3753 3006
Peter King +44 20 3753 3139
Christoph Kleinasser +44 20 3753 3063
Chris McKeand +44 20 3207 7938
Simon Messman +44 20 3465 2754
AJ Pulleyn +44 20 3465 2756
Michael Schumacher +44 20 3753 3006
Paul Somers +44 20 3465 2753

### EQUITY TRADING
**HAMBURG**
David Hohn +49 40 350 60 761
Gregor Labahn +49 40 350 60 571
Lennart Pleus +49 40 350 60 596
Marvin Schweden +49 40 350 60 576
Linus Weidner +49 40 350 60 798
Philipp Wiechmann +49 40 350 60 346
Christoffer Winter +49 40 350 60 559

**LONDON**
Edward Burlison-Rush +44 20 3753 3055
Richard Kenny +44 20 3753 3083

### ELECTRONIC TRADING
Daniel Eichhorn +49 40 350 60 391
Matthias Führer +49 40 350 60 597

## BERENBERG CAPITAL MARKETS LLC

Member FINRA & SIPC

E-mail: firstname.lastname@berenberg-us.com

### EQUITY SALES

#### SALES
Kelleigh Faldi +1 617 292 8288
Isabella Fantini +1 646 445 4861
Shawna Giust +1 646 445 7216
Rich Harb +1 617 292 8228
Zubin Hubner +1 646 445 5572
Jessica London +1 646 445 7218
Ryan McDonnell +1 646 445 7214

#### SALES (cont'd)
Emily Mouret +1 415 802 2525
Peter Nichols +1 646 445 7204
Kieran O'Sullivan +1 617 292 8292

#### CRM
Laura Cooper +1 646 445 7201

#### CORPORATE ACCESS
Olivia Lee +1 646 445 7212
Tiffany Smith +1 646 445 4874

#### EVENTS
Patricia Ehrhart +1 646 445 4863

### SALES TRADING
Christopher Kanian +1 646 445 5576
Lars Schwartau +1 646 445 5571
Brett Smith +1 646 445 4873
Bob Spillane +1 646 445 5574

### ECONOMICS
Mickey Levy +1 646 445 4842
Roiana Reid +1 646 445 4865