December 6, 2013

"Tapering"

In our May 2013 Commentary[1], we made our first reference to the potential for the Federal Reserve Bank to "taper" its policy of quantitative easing (QE). Specifically, we made two important points: first, the Fed would not commence tapering unless and until there were signs of a "sustainable recovery;" and, second, the Fed would "err on the side of pushing a little too far towards inflation rather than the other way around." Based on this, we explained how there were tangible improvements in the state of the economy, but it remained unlikely for the Fed to conclude we were in a "sustainable recovery."

The Market Skeptics Versus the Fed

Market participants have consistently been ahead of the Fed in expecting a step back from the aggressive policies implemented to lift our economy out of the Great Recession. This makes sense in light of how the economy as represented by the stock market has improved at a much quicker pace than the "real" economy—the so-called "Wall Street" vs. "Main Street" dichotomy. While this is a relevant distinction, it is not the only point missed by the discourse surrounding whether the Fed will or will not taper. When Wall Street analysts speak of tapering, they are implying something deeper, which many market skeptics openly and regularly lament: there is this notion that tapering is a major risk to the stock market. The skeptical argument goes as follows. "The stock market is not rallying for fundamental reasons. The economy is not really improving. This rally is happening purely because of QE." The follow-on logic is that as soon as QE ends (aka tapering begins), then the rally will all fall apart. Again, the embedded assumption here is that the real economy has not improved, but the stock market itself has rallied.

It is clear that something does not add up. The Fed has maintained it will not end QE unless and until we have a sustainable recovery, while the skeptics are arguing the end of QE will lead to a stock market correction because we have not had a sustainable recovery. These two positions are mutually exclusive, unless the skeptical argument is actually that the Fed will be fooled into thinking there has been a sustainable recovery, when in fact there has not. It is important to point out the inconsistency in the fact that those most skeptical of QE are calling for its immediate end now despite this contradictory reality. We think this sheds more light on the biases possessed by these skeptics than it does the state of the economy.

[1] http://www.rgaia.com/wp-content/uploads/2013/07/may-213.pdf

Alongside this skeptical refrain has been the meme-ification that "good news is bad news." This amplifies the inconsistency in the skeptical argument against QE, for if this is all an illusory stock market rally due to QE, then good news would in fact be good news independent of any Fed policy path. This notion is a textbook example of absurdity. Yes indeed, good news is in fact good. It amazes us that such a simple point of fact needs to be said in this environment.

The Pen (or Microphone) IS Mightier than the Sword

With this heated discussion about taper, the Fed has effectively accomplished two things: first, the Fed has essentially completed the first round of interest rate hikes purely through the power of communication; and second, the Fed has also helped flush out what may have been overly speculative positions in bond markets in particular. Chairman Bernanke made an important observation regarding the former fact in a speech during November, which also addresses some points talked about above and sets the stage for our discussion of the latter[2]:

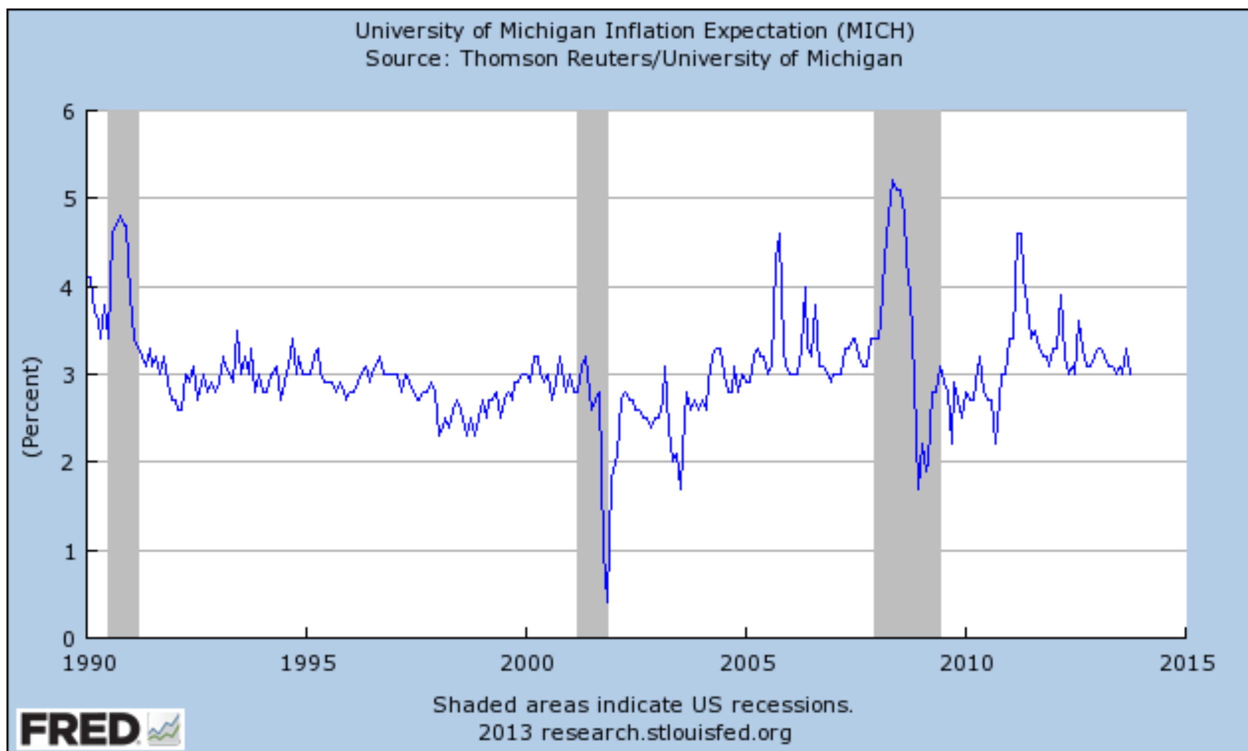
> Financial market movements are often difficult to account for, even after the fact, but three main reasons seem to explain the rise in interest rates over the summer. First, improvements in the economic outlook warranted somewhat higher yields--a natural and healthy development. **Second, some of the rise in rates reportedly reflected an unwinding of levered positions--positions that appear to have been premised on an essentially indefinite continuation of asset purchases--together with some knock-on liquidations of other positions in response to investor losses and the rise in volatility. Although it brought with it some tightening of financial conditions, this unwinding and the associated rise in term premiums may have had the benefit of reducing future risks to financial stability and, in particular, of lowering the probability of an even sharper market correction at some later point.** Third, market participants may have taken the communication in June as indicating a general lessening of the Committee's commitment to maintain a highly accommodative stance of policy in pursuit of its objectives. In particular, it appeared that the FOMC's forward guidance for the federal funds rate had become less effective after June, with market participants pulling forward the time at which they expected the Committee to start raising rates, in a manner inconsistent with the guidance. (emphasis added)

It is impossible to know whether this "unwinding" was willful on the part of the Fed, but it did in fact help set the stage for a reduction in the impact of a policy shift once tapering does in fact occur.

In our July 2012 Commentary, we marveled at how "Mario Draghi, the President of the European Central Bank, through muttering a few words, sent global markets higher by more than 2%. And you

[2] http://www.federalreserve.gov/newsevents/speech/bernanke20131119a.htm

know what they say: 'actions speak louder than words.' Communication has played an immensely important role in the toolkit of central bankers in dealing with crisis. Since Draghi's strong utterance, policymakers in Europe have followed through with some action, though the catalytic event remains simply the powerful statement towards "the irreversibility of the Euro.[3]" One of the hallmarks of Ben Bernanke's tenure as Fed chairman has been his emphasis on clarifying and improving the Fed's communication. We think one chart in particular highlights the real-world impact of this point nicely:

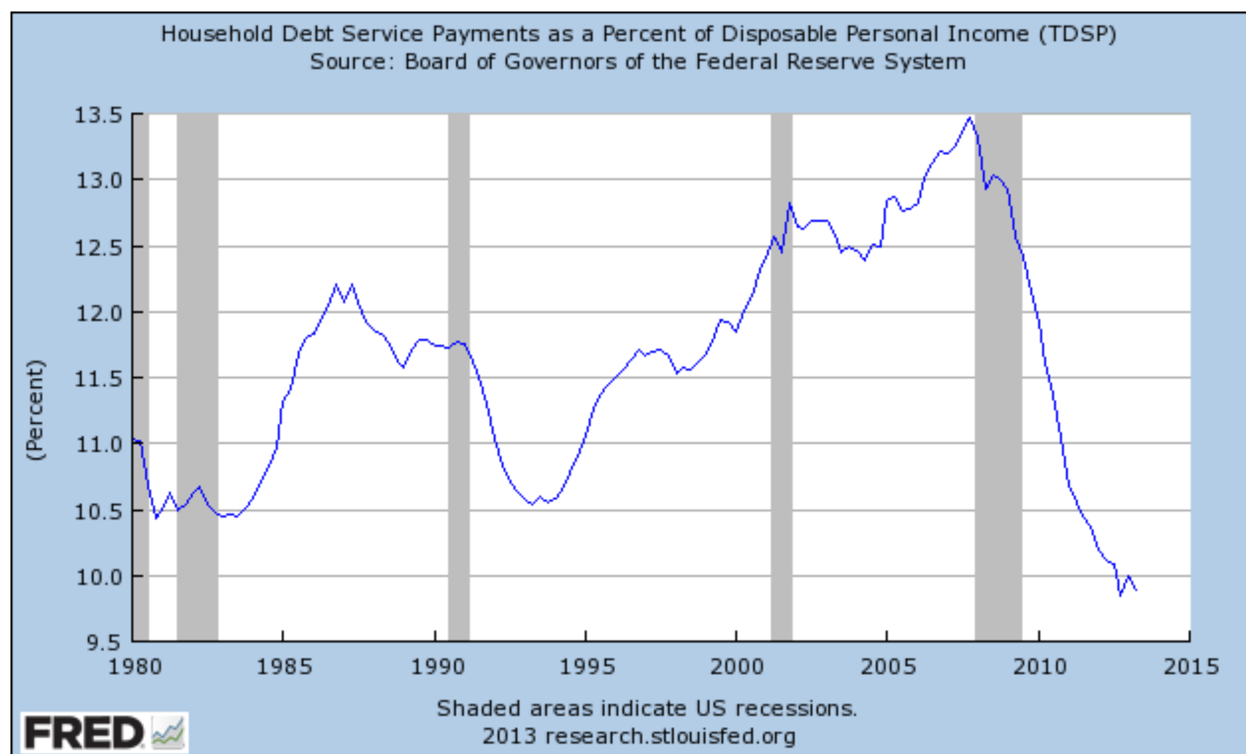


This chart shows inflation expectations since 1990 based on a survey conducted by the University of Michigan. Expectations serve an important role, because they reflect what the average person thinks, rather than what actually and necessarily will transpire. In the Great Recession (2007-2009), the U.S. faced by far its greatest risk of a deflationary spiral, yet notice how inflation expectations never went negative, and never got close to the depths they did in the recession following the bursting of the

[3] http://www.telegraph.co.uk/finance/9417209/The-euro-is-irreversible-and-not-in-danger-says-Draghi.html

DotCom bubble. Credit for this goes to Chairman Bernanke for how effectively he conveyed the role Fed's policy would play in aiding an economic recovery.

In terms of how things have played out in markets, the tapering conversation alone looks very much analogous to an actual hike in interest rates. This is an important point considering the Federal funds rate set by the Fed remains at zero. In fact, we have long argued that the role of QE itself is to help the Fed communicate its intent to maintain the zero interest rate policy (ZIRP) for longer than the market has believed. This is so, because between each round of QE, the market has repeatedly turned its attention towards when the first rate hike would occur, despite the Fed's language that rates would remain at zero for an "extended period." With QE in place, all this consternation focuses instead on the QE debate, while interest rates have remained low throughout the yield curve, affording all sectors of the private economy ample opportunity to restructure their debts. This too gets at one of our favorite, most telling charts; the one which shows the household debt service as a share of income:



This highlights just how far household balance sheets have come. Balance sheets have quickly evolved from being overburdened by debt, to having even greater flexibility with financing than any point before the prior two boom periods.

Again we want to emphasize that this entire conversation about an imminent end to QE comes on the heels of improving economic data, and while some view these higher Treasury rates as cause for concern, we view them as a reflection of the underlying improvements. This is something that should make us all feel more comfortable about where the economy is, and is heading, and not something anyone should lose sleep over.

There is another point to make about communication. This year will mark the end of Bernanke's term as Fed chairman, after which he will be replaced by Janet Yellen. Many credible Fed insiders have stressed Janet Yellen's high regard for communication as a Fed policy tool and believe she will use it to an even greater degree than Bernanke has. This will be worth watching (and listening to) moving forward.

Moving Forward

While we never make decisions based on Fed policy, we think it is very important to address and add context to the many concerns hitting mainstream media about a potential shift in Fed policy. This is reflection of strength, not a projection of fear for financial markets. It is also important to remember that the stock market and the economy do not necessarily move in lock-step. Sometimes the stock market is ahead of the economy, and sometimes it behind. This is merely part of why picking tops and bottoms is a challenging task. Equally important is acknowledging the reality that when the stock market outperforms its long-term annual average return by a wide margin in a calendar year, it is pulling forward future returns. To that end, we do not expect future returns to be nearly as strong as they have been these past two years. This is a simple reality lost on many. Lastly with regard to the stock market, when a large coefficient of the return stems from an increase in the market's multiple (P/E ratio expansion of the broader indices), then the protection afforded by valuation is inherently lessened. Higher valuation alone is not a risk in and of itself. Too many are making this misguided case. This reality simply means that in the event of a shock, the market has more downside risk than it has in the recent past. These points matter more in the context of how they should shape our expectations moving forward than they do in terms of the actual risks facing our companies' earning power.

Despite the market's continued rally, we see little reason to change our overall positioning. As we explained in recent months, we have a healthy allocation to equities in Europe, which are only impacted indirectly by Fed policy, and we already trimmed our lower conviction US positions. Our cash balance

remains rather plush. If the market keeps grinding higher, it is all but certain some of our remaining positions will pass the upper reaches of our fair value range at which point further selling would be warranted, though there are no guarantees.

One market disconnect that we have bought into is the muni bond market. We will look to increase our stake in this area over the coming months. This asset class is sensitive to interest rates considering its long duration, though through the use of vehicles like Closed End Funds, many of which are trading at steep discounts to their net asset values, we think we can both mitigate risk and put ourselves in position to generate a nice return.

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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