1Q 2013 Market Insights
Neither an Arbiter nor Speculator Be
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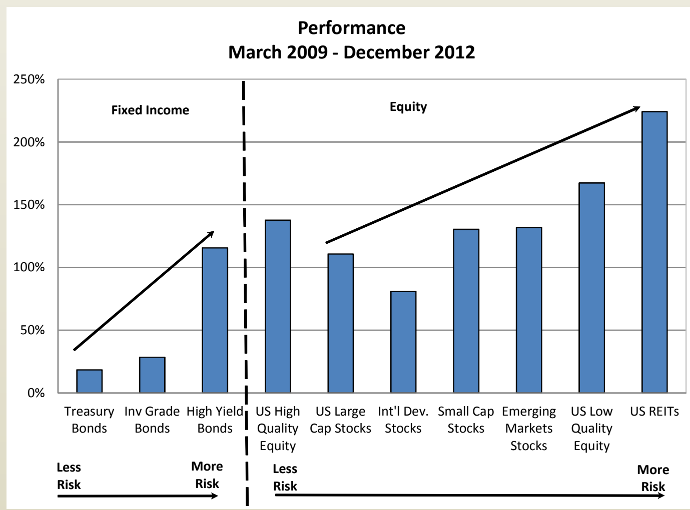
“…..the Fed should use monetary policy to target the economy, not the asset markets. As I will argue today, I think for the Fed to be an "arbiter of security speculation or values" is neither desirable nor feasible.” – Ben Bernanke

Over long periods of time, financial market prices respond to fundamental variables like long term earnings and cash flows. In the short term, behavioral and political influences can have both a positive and negative impact on asset prices. This includes central bank policy measures. These shorter term influences tend to be just that, shorter term; in essence borrowing return from tomorrow to satisfy the animal spirits of today. Ironically, the quotation above was taken from a speech by Ben Bernanke in October of 2002 regarding asset price bubbles and monetary policy. In his remarks, Mr. Bernanke suggests that targeting asset markets in the face of an inflating bubble is dangerous and shouldn’t be done. This quarter’s Market Insights will focus on recent Fed policy and how their actions would seem to contradict their earlier position on asset markets.



From market lows in March of 2009, financial markets have rallied handsomely. Within equity and fixed income assets, the trend has been a reward for risk taking with risk assets outperforming non-risk assets handsomely.

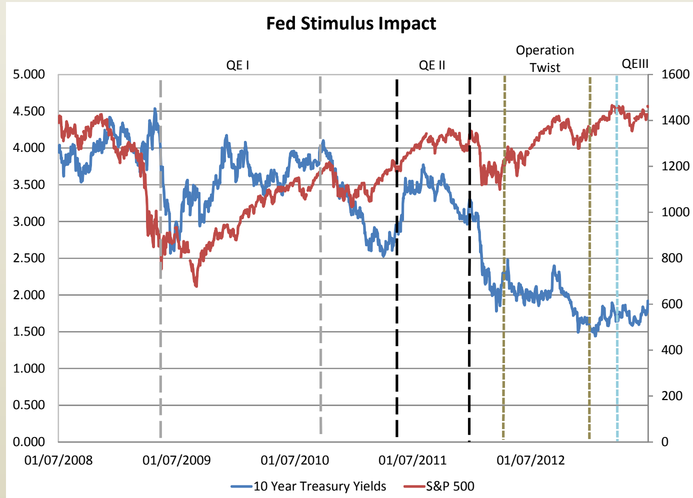
Indexes cannot be invested in directly, are unmanaged and do not incur management fees, costs and expenses.

Source: MPI Stylus, Barclay’s Capital, MSCI, Russell Investments, Standard & Poors, FTSE

<u>Quantitative Stimulus</u>

Beginning in the days of the financial crisis, markets got their first taste of what would come to characterize financial market performance over the next four years. Specifically, in November of 2008, in an attempt to stabilize financial markets, the Fed announced what would become the first of four unconventional monetary policy events (there have been 3 QE events plus Operation Twist). Typically, the primary tool used by central bankers in implementing monetary policy is via the interest rate channel. By reducing interest rates and the cost of money, central bankers can entice borrowers with low rates. The added borrowing is then re-spent into the economy creating an economic boost. With interest rates trapped at zero, this is no longer possible. As such, central bankers have turned to quantitative measures. Quantitative easing is an unconventional policy tool where the central bank buys financial assets in the open market. The goal is to increase the money supply, typically in the form of excess reserves in the banking channel. Here is the catch. As we have discussed at length in recent Market Insights, excess reserves in the banking system are hardly the problem. In fact, there is a mountain of liquidity in the banking system. For a variety of reasons, banks are simply not lending.

As a result, the Fed has turned to an even more unconventional method. That is targeting a wealth effect. While the process is similar, the goal is somewhat different. By adding liquidity to our economic system, the Fed has designs on increasing the price of financial assets (anything other than treasury bonds). By doing this, they operate outside of the banking system by creating gains in stocks and bonds. These gains are either harvested and respent into the economy or by increasing prices, the cost of capital to the issuer declines which is also stimulative. As seen in the table below, risk assets have done quite well in periods leading up to and during periods where the Fed has acted with quantitative measures. In fact, the S&P 500 has advanced by nearly 100% during periods where the Fed has injected money into the system. What is



Since 2008, equities have responded to stimulus measures and little else.

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Source: Federal Reserve Board, Standard & Poors

	QEI 11/25/08 - 03/15/10	Post QE I - 03/16/10 - 08/09/10	QEII Hint - 08/10/10 - 06/22/11	Post QEII - 06/23/11 - 09/20/11	Operation 09/21/11 - 06/29/12	QEII Hinted - 07/02/12 - 12/31/12
Barclays Treasury TR USD	2.79	5.3	2.07	5.24	2.79	0.48
BC Aggregate Bond	13.69	4.62	3.12	3.34	3.42	1.8
BC High Yield Corporate Bond	79.41	5.12	10.4	-2.59	10.67	7.97
S&P 500 High Quality	43.63	2.35	19.84	-6.18	15.75	6.3
S&P 500 Index	39.44	-1.27	16.17	-6.12	15.28	5.95
MSCI EAFE	44.51	-0.45	12.25	-14.67	3.2	13.95
Russell 2000	57.61	-1.74	22.57	-13.45	17.11	7.2
MSCI EM (Emerging Markets)	108.06	4.65	11.94	-14.05	0.5	13.75
FTSE NAREIT All Equity REITs	66.06	10.6	18.47	-6.98	21.76	4.17
S&P 500 Low Quality	95.24	-1.49	21.49	-12.73	13.03	10.98

Markets have become seemingly reliant on Fed stimulus for sustained gains. The S&P 500 has advanced 97.85% in the stimulus driven environments above and has fallen -7.31% in the absence of stimulus.

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Source: MPI Stylus, Barclay's Capital, MSCI, Russell Investments, Standard & Poors, FTSE disturbing is the emerging trend of no stimulus, no gain. In periods lacking Fed support, US equities have fallen by more than 7% over this same period. Regardless of the justification, financial markets have seemingly come to depend on liquidity induced rallies for markets gains.

Robbing from Peter to Pay Paul

Clearly, as stated above, one can see that the Fed has been highly effective at creating their desired wealth effect. It is, however, highly debatable as to what the economic benefit of this policy course has been and at what long term cost. At least in part, higher inflation in some form will be the result of taking this path. I would suspect that Chairman Bernanke and his colleagues recognize this and have accepted, if not embraced, the idea of a modest increase in prices. The question then becomes how quickly can the Fed reverse course before the Titanic hits the iceberg? Remember, it took us four years to get here.

Sadly, inflation is not the only casualty in this battle. By using quantitative measures to create a wealth effect and in turn stimulate economic activity, the Fed is in essence robbing Peter to pay Paul. That is, they are borrowing tomorrow's returns to fund the economic ambitions of today. Allow me to explain using an example. Let's start with some general concepts. First, as discussed in our 2nd quarter Market Insights, real stock returns are created through certain fundamental inputs like dividends, growth of real earnings per share and P/E multiple expansion. The first two represent what one can think of as long term sustainable return. This is the return that is created through earnings and is encapsulized in something called earnings yield (the inverse of the P/E Ratio). Using a Price/10 Year Average Earnings (P/E10) as a measure of both current valuation and long term fair value, we know that the long term average P/E10 is 16.5. It reached a low of 13.25 in March of 2009 and returned to fair value five months later. In the process, the return was 35.62% almost entirely attributable to a change in the P/E multiple. From fair value, the earnings yield or long term sustainable return is expected to be 6% per year (for 3 years and 5 months) producing a cumulative gain of 22.03% over the period. Add in 7.16% for inflation and that leaves us with a rather hefty gain of 64.81% over the most recent 3 ½ year period (more than 14% annualized). This is the level of return that the market

Source of Return	Return %
Multiple Expansion From Market Lows to Average(March 2009 - July 2009)	35.62
Infaltion(August 2009 - December 2012)	7.16
Compounded Earnings Yield(August 2009 - December 2012)	22.03
Sustainable Return March 2009 - December 2012	64.81
Actual Total Return	110.7
Temporary Return	**45.89**

Creating a wealth effect through Fed policy has little impact on the earnings component of return and is achieved mostly through an expansion in the P/E multiple. This form of return can be considered temporary and is akin to borrowing return from tomorrow to stimulate economic growth today.

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Source: iCM Capital Markets Research, Standard & Poors, MPI, Morningstar could sustain without invading tomorrow's return which is exactly what we have done. The actual return during this time was more than 110%. The remaining 45.89% is again gains attributable to multiple expansion, this time stretching valuations above the average. If this were amortized over a 10 year period, the result would be a headwind to equities to the tune of 3.84% per year. In practice, there are other variables that must be taken into consideration when determining the true level of over valuation in an asset including the price level of competing assets. The purpose of this analysis isn't to suggest imminent doom as much as it is to caution risk takers and more importantly to highlight the consequences of recent policy action. As a result, we don't consider equities to be quite that overvalued but we certainly do believe that we have sacrificed a significant amount of forward looking return during the past 4 years.

The title of this article *Neither an Arbiter nor Speculator Be* is of course a play on Mr. Bernanke's quote from 2002 and the Shakespearian quote "neither a borrower nor lender be." In essence what Mr. Bernanke suggested in 2002 is that the Fed should not interfere in asset markets. In the presence of a bubble, there is no such thing as "safe popping" and the very action of popping a bubble may create an economic downturn. By definition, isn't a bubble the level of valuation beyond what can be supported by the fundamental earnings and cash flows of the business? As such, creating a wealth effect by artificially inflating asset prices is in practice inflating a bubble. Regardless of the justification, this would seem to be akin to letting the proverbial genie out of the bottle; once he is out how do you get him back into the bottle? As always, we continue to be vigilant in monitoring that situation and remain uniquely suited to respond on behalf of our clients to an ever evolving environment. Thank you for your trust and confidence.

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