The Federal Reserve and the Great Experiment

Looking back on the financial crisis of 2008-2009, Ben Bernanke and the Federal Reserve played a decisive role in saving the United States from a much deeper meltdown. As a student of the Great Depression, Ben Bernanke understood the risk of a deflationary spiral and the mistakes the Fed made in the 1930's by allowing the money supply to contract, so he committed to doing whatever was necessary to avoid the same outcome. In doing so, the Fed was instrumental in bailing out struggling institutions, driving short-term interest rates down to near zero percent, and printing trillions of dollars to purchase government bonds in the open market. These measures combined to put a floor under the markets, restore confidence to the system, and kick start economic activity once again. As the recovery has evolved, sluggish growth and stubbornly high unemployment have caused the Fed to keep their foot on the accelerator and print trillions of more dollars to fund their "quantitative easing" programs. The resulting explosion in the Fed's balance sheet has led many investors to start to question whether the long-term risks to such policies outweigh the short-term benefits. In this month's MAInsights, we will offer our view on the consequences of the Fed's actions and how they have influenced our portfolio positioning.

Positive Consequences

No Double Dip - Starting with the financial crisis of 2008-2009 and with every "growth scare" that has succeeded it, the Fed has been extremely proactive in assuring markets that they would step in with additional support if and when the economy needed it. As a consequence of Fed support, the U.S. economy avoided a contraction in 2010, 2011, and 2012 despite signs of slowing each year and resisted the deflationary forces emanating from the European debt crisis. Interestingly, the Fed has had more success with preventing a deteriorating situation than they have with boosting real GDP growth - more on this point in the following section.

Healthier Banks - Quantitative easing, in simple terms, involves the Fed printing money to purchase financial assets from banks. Under normal circumstances, banks would then use these proceeds to make new loans to consumers and businesses and thus stimulate economic activity, but with increased regulatory oversight and stricter lending standards following the sub-prime mortgage crisis, most of the new cash has sat idle in their vaults. In our view, this has been the main reason QE has been unsuccessful in creating "escape velocity" for the economy and we have been struggling to return to normal growth. On the positive side, however, QE has enabled banks to recapitalize their balance sheets and manage through their non-performing loan portfolios, making today's financial system much less vulnerable to a new downturn and much closer to a stronger lending environment.

Higher Asset Prices - Ben Bernanke has said on several occasions that one of the main goals of the Fed's easy monetary stance was to lift asset prices - and thus far, this has absolutely worked. With interest rates at all-time lows and the Fed providing a backstop for the economy, investors have been incentivized to take more risk in their portfolios. Everything from stocks to real estate to gold to high yield bonds have benefitted from the increasing support from the Fed and the absence of a risk-free return. Higher asset prices have created a positive wealth effect in the economy and may be part of the reason consumer spending has remained resilient despite minimal wage growth and high unemployment.

Negative Consequences

Financial Repression - The term "financial repression" refers to any measure used by a government to direct funds to themselves that, in a deregulated market, would likely go elsewhere. The most common motive for financial repression is to reduce debt burdens without having to enact politically dangerous fiscal austerity. The most common means of financial repression is by setting an abnormally low interest rate (often below the rate of inflation) so that borrowing costs of an indebted sovereign are actually negative after adjusting for inflation. Does this all sound familiar? It should, because this is exactly the tactic that the U.S. is taking today by keeping interest rates at extremely low levels and actively "interfering" in the free market with their bond-buying programs. In fact, Strategas Research Partners estimates the Federal Reserve is now purchasing between 75-100% of new treasury issuance and 70-80% of new agency mortgage-backed security issuance. In doing so, they are keeping interest rates well below the level that the free market would naturally assign and providing a benefit to the U.S. government at the expense of savers and investors. This financial repression is a subtle, often overlooked "tax" on investors as it lowers inflation-adjusted returns and potentially creates a moral hazard by rewarding irresponsible behavior over responsible behavior.

Threat of Currency War - With nearly the entire developed world mired in debt, the Fed is not the only central bank trying to restrain interest rates and weaken its currency. For example, Japan recently enhanced its own quantitative easing program and saw its currency drop a precipitous 20% against the U.S. dollar since November 2012. The Bank of England has been doing QE since 2009 and recently hinted they would do more if growth continues to be weak. The European Central Bank has also gotten in on the action, and while they have yet to enact outright quantitative easing, they have provided unlimited liquidity to European banks and stand "ready to do whatever it takes" to preserve the Eurozone. With the ever-increasing level of globalization, the consequences of these actions are not isolated to the home countries alone. For emerging market economies like Brazil and China who have stronger financial positions, the financial repression in the developed world causes their currencies to appreciate which, in turn, slows their export business. As such, we would expect these countries to fight back with policies to limit their own currency's appreciation and reinforce the ongoing "race to the bottom." This type of currency manipulation could lead to market distortions in the long run - including asset bubbles, bouts of high inflation, and/or economic instability.

A Dependent Patient - As the recovery in the equity market has progressed, it has become clear that the market is abnormally dependent on the Fed. In fact, according to work done by David Rosenberg of Gluskin Sheff, the correlation between the Fed's balance sheet and the S&P 500 stands at 85% today, more than four times its historical relationship and actually higher than the correlation between the market and corporate earnings. Each time the Fed has taken a break from supporting the market, the economy has stalled and markets have sold off. If this is the best signal to watch to predict market direction, then the announcement that the Fed will support the market until we reach 6.5% unemployment is certainly good news for stocks. At the current pace, the Fed's balance sheet will expand from $2.8 trillion to $3.8 trillion in securities in 2013 - which will represent 23% of U.S. GDP and $3 trillion more than they held prior to the first round of QE. In this type of liquidity backdrop, the adage "don't fight the Fed" will likely work again this year and possibly for several years, but investors should be wary of the day the Fed finally begins to withdraw the medicine.

Portfolio Strategy

The Great Experiment at the Federal Reserve has been front-and-center in our discussions on how best to allocate portfolios. In many ways, the Fed's enormous role in the economy trumps the fact that earnings growth is mediocre, the debt ceiling sequester is likely to go through, and it is politics as usual in Washington. With the wall of liquidity providing a backstop for the markets, in our view, the economic fundamentals do not need to be stellar for the market to continue higher. In fact, in a non-intuitive way, a very strong economy might make us less optimistic about asset prices if that means the end to the Fed's easy stance. But for now, we are tactically constructive on equities with an emphasis on dividend-payers and businesses tied to faster-growing emerging markets.

The Fed's policies have had the largest impact on our fixed income allocations as their foray into financial repression has driven interest rates down to extremely low levels and made most traditional fixed income investments unattractively priced. At the margin, we have been focused on identifying alternative ways to generate income that provide higher yields and more inflation protection. In that context, we continue to favor pipeline MLPs, fixed-to-float preferred securities, and global debt. Additionally, given the enormous amount of money printing set to take place this year and beyond, we also like the outlook for gold and gold miners and expect them to perform well in a negative real rate environment.

With the unprecedented influence of central banks and global policymakers on the markets, the traditional way of investing in stocks and bonds has become seriously challenged. As a result, finding more creative ways to generate attractive risk-adjusted returns has become our focus while remaining true to our commitment to preserve and grow your wealth. As always, we appreciate and value the confidence you have placed in us and will work every day to help you achieve your investing goals.

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