Outlook on the **United States**

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As the second quarter came to a close, the market anxiously contemplated the prospect of a change in the US Federal Reserve's (the Fed's) monetary policy. Conflicting statements from members of the Federal Open Market Committee (FOMC) and a contentious question-and-answer session during Fed Chairman Ben Bernanke's May 22 Congressional testimony whipsawed debt and equity markets globally, and the term "tapering" became a part of our daily vernacular. Finally, on June 19, the FOMC concluded a two-day meeting with its normal policy statement, revised economic projections from the Fed board members and presidents, and a press conference. While there were both dovish and hawkish points of note, investors focused on the more negative perspective: that the exceptionally loose monetary policy spawned by the financial crisis must inevitably end at some point. Unfortunately for markets, that point might be nearer than people had previously believed. In this outlook, we parse the various aspects of the FOMC communications, explain why we believe it will take several years for monetary policy to completely normalize, and explore why investors might currently be more alarmed than they should be.

The Quarter Behind

In the second quarter, the gathering momentum of the US recovery was evident on numerous fronts:

1. **House prices continued to rebound.** The S&P/Case-Shiller 20-City Home Price Index continued to recover through the seasonally weak winter months. The latest results (released on June 25, 2013) for transactions from February through April showed that home prices have increased 12.1% from a year ago. Prices increased in all 20 of the cities within the index, but by widely different degrees. Home prices in Las Vegas, San Francisco, and Phoenix increased over 20%, while those in the New York metropolitan area rose only 3.2%.

   The key differentiator among the cities is whether they are in judicial or non-judicial states. In the former, a lender must appear before a judge to foreclose on a home, while in the latter, the process is much less cumbersome. As we have discussed in our series of housing updates, the latest of which is the *Update on the Improving Foundations of US House Prices (June 2013)*, prices in non-judicial states overshot to the downside as a result of a flood of supply that hit the housing markets when demand was weakest. Now, this "shadow inventory" in these non-judicial states has dissipated, and there are actually supply shortages. In contrast, judicial states have extended timelines for resolving defaulted mortgages, and continue to labor under a massive shadow inventory. As an example, one bank CEO told us that, in the first five months of 2013, his firm has only been able to move 0.1% of its loans that are over 60 days past due into foreclosure in New York State (a judicial state). He went on to say that, of the loans that are over 60 days past due, the average time that a loan has been in default in New York State now exceeds 1,000 days. Given this situation, we maintain our expectation that price performance will diverge between judicial and non-judicial states as the economy continues to recover and housing finance markets are reformed.

   Despite the headwinds in judicial states, we continue to expect incremental upside in US house prices, as explained in the most recent US housing update noted above. Our optimism is reinforced by the current data from the National Association of Homebuilders Housing Market Index, which jumped to its highest level since March 2006. This index is a composite of three underlying indices, which represent the following metrics: current single family residential sales, single family sales over the next six months, and prospective buyer traffic. All three of these areas reached new seven-year highs, indicating bright prospects for the broader housing market going forward.

2. **Household assets and net worth reached new record highs.** The Fed reported that total household assets eclipsed the pre-crisis peak, reaching $83.7 trillion at the end of the first quarter of 2013 (according to the Flow of Funds report released June 6, 2013). Financial assets also rose to a record high of $57.7 trillion—8% above the pre-crisis peak. Equity holdings (both direct and indirect) have recovered all of the losses incurred during the financial crisis, and now account for $22.5 trillion of household financial assets. Those riding the equity rollercoaster over the last several years have been left feeling sick as a result of the sharp market oscillations, which began with the steep decline from $22.1 trillion in 2007 to a bottom of $11.0 trillion early in 2009, before doubling back to its highs only four years later. As we have discussed before, the bulk of equity holdings tend to be concentrated in a relatively narrow segment of the population. As of 2010, the Fed reported in its Survey of Consumer Finance that only 49.9% of American households owned any equities, whether directly or indirectly. This figure was down from its 2007 high, when 53.2% of households were equity owners. Moreover, the median value of holdings for households that did own equities was only $29,000.

   The remainder of household financial assets is comprised primarily of pension fund assets (excluding equities, which are included in the $22.5 trillion noted above) of approximately $11.0 trillion, bank deposits and money market balances of just over $9.0 trillion, ownership of unlisted businesses at $8.3 trillion, and credit instruments at $5.5 trillion.

Another main driver of asset recovery more recently has been residential real estate owned by households, which has increased from a low of $16.2 trillion to $18.5 trillion as of the first quarter.

While assets have recovered, households continue to pay down debt, effectively magnifying the increase in net worth. Total household debt has now declined from 98% of GDP in the first quarter of 2009 to 80% of GDP in the first quarter of 2013. The balance of debt has also declined from a peak of $14.4 trillion in the third quarter of 2008 to $13.4 trillion in the first quarter of 2013. Of this debt, $9.4 trillion is mortgage debt, and the remaining $4.0 trillion is roughly divided evenly between credit cards, auto loans, and student loans, as well as some other small debt obligations. Household net worth now stands at $70.4 trillion, an $18.3 trillion or 35% increase from the financial crisis low in the first quarter of 2009.

3. **Federal fiscal deficits declined.** In mid-May, the Congressional Budget Office (CBO) released its updated forecast for US federal government deficits through the next 10 years. The report provided an upside surprise, as the anticipated deficit for the fiscal year ending September 30, 2013 is now expected to fall to only 4.0% of GDP.

   Two factors drove the deficit decrease:

   a) A one-time accounting benefit at Fannie Mae and Freddie Mac allowed the two government-sponsored entities to repay $95 billion to the US Treasury, and

   b) the CBO increased its projected revenue by $105 billion amid higher-than-expected receipts from individuals and corporations.

   However, the projection of a 4.0% deficit-to-GDP ratio might still be too high, as the CBO is assuming nominal GDP growth in 2013 of only 2.9% versus the private sector consensus of 3.4%. If GDP is higher than the CBO expects, the deficit would be lower than 4.0%. To the extent nominal GDP growth remains at 4% or higher, deficits of a similar or smaller magnitude imply that the total stock of federal debt relative to GDP will stabilize, or even begin to decline this year. Considering this situation from an optimistic perspective, the federal government can begin to normalize spending and tax decisions rather than lurch from crisis to crisis (as has been its reaction historically). However, the downside of lower deficits is that the pressure for government officials to agree on substantial entitlement or tax code reforms decreases as a crisis appears less imminent.

Looking Ahead

The Fed and its decisions regarding monetary policy are in the forefront of most investors' minds as we enter the second half of the year. Recent confusion has been somewhat resolved by the release of the Fed's minutes and press conference on June 19, and we feel it is useful to parse the key events and points from these to build a base case scenario for how events might play out over the next several years.

Key points as background:

1. The secular trends of deleveraging, re-regulation, and widening gaps in society remain in place. The private sector has deleveraged substantially, but the public sector has not yet begun to do so. Many regulations mandated by legislation in the United States over the last five years have not been written, much less implemented. The widening wealth gaps and tough decisions regarding prioritizing the needs of different parts of society, such as those of the elderly population versus those for younger generations, persist.

2. Exogenous risk factors such as the euro zone crisis and lack of visibility around a slowing and rebalancing Chinese economy could resurrect systemic risk.

3. Deflationary pressures remain prominent globally, including:

   a. Structural reforms in the euro zone, which generally reduce unit labor costs and increase the ability of employers to terminate workers and replace them with more productive and/or less expensive employees.

   b. Structural reform expected to occur in Japan, much of which has the objective of making Japanese companies more competitive with lower prices and higher productivity.

   c. China's transition to a different role, as the country no longer serves as the deflationary force it has been for years. Historically, low Chinese labor costs drove global deflation. Now, the decelerating economic growth rate in China is leading to lower commodity prices, as supplies of metals and other inputs have grown substantially to this point based on the assumption that Chinese demand growth would be unending.

4. All of these factors combined lead us to believe that US economic growth is unlikely to exceed a range of 1% to 3% in real terms over the next several years. Meanwhile, US inflation rates have also decelerated despite massive quantitative easing (QE) in recent months. We believe deflation may be the bigger risk for the Fed in spite of global QE given the ongoing slack in the labor market.

We believe the Fed has been sending mixed messages to markets through much of the quarter, perhaps on purpose. From our perspective, this may be because the Fed wants to test how markets will react to the ultimate end of loose monetary policy, and in an effort to begin to identify where the excesses are in various asset classes that might be problematic when rates normalize.

The FOMC statement and Bernanke's subsequent press conference, in particular, conveyed a range of mixed messages. The main points of these are outlined below, categorized by sentiment.

Hawkish comments included:

1. The statement that "downside risks to the economy and the labor markets have diminished since the fall."
2. Lowered expected unemployment rates from the end of 2013 to 2015 by 10 to 30 basis points (bps).
3. Indication that the Fed is likely to begin reducing its monthly purchases of securities "later this year," and would continue decreasing the pace of asset purchases "in measured steps through the first half of next year, ending purchases around mid-year," assuming economic projections are accurate. As importantly, Bernanke indicated that an unemployment rate "in the vicinity of 7%" would be the likely level in mid-2014 when purchases end, implying that the Fed might be targeting this level.

Dovish comments included:

1. Decreased 2013 nominal GDP growth expectations. Lower nominal GDP implies a smaller denominator for measuring debt-to-GDP ratios at year end.
2. Lowered expected federal funds rate at the end of 2014. The average rate expected by the 19 projections declined from 55 bps to 43 bps.
3. Reiteration that policy decisions will depend on the incoming data and "evolution of the outlook." Bernanke also described tapering as being akin to easing off the accelerator in a car rather than applying the brakes, and added that "any need to consider applying the brakes by raising short-term rates is still far in the future."
4. Clarification that "a strong majority" of the FOMC "now expects that the committee will not sell agency mortgage-backed securities (MBSs) during the process of normalizing monetary policy." If this was intended to reassure MBS owners, it failed, as MBS yields rose over 60 bps in the course of the following days. When this increase is passed through to mortgage borrowers, it would imply that the cost of home financing jumped 6% higher in one week, with no policy action at all.

Two days later, Federal Reserve Bank of St. Louis (the St. Louis Fed) President James Bullard, traditionally considered an inflation hawk and one of two dissenters from the FOMC decision, posted a statement on the St. Louis Fed's website explaining his vote:

> ST. LOUIS – Federal Reserve Bank of St. Louis President James Bullard dissented with the Federal Open Market Committee decision announced on June 19, 2013. In his view, the Committee should have more strongly signaled its willingness to defend its inflation target of 2 percent in light of recent low inflation readings. Inflation in the U.S. has surprised on the downside during 2013. Measured as the percent change from one year earlier, the personal consumption expenditures (PCE) headline inflation rate is running below 1 percent, and the PCE core inflation rate is close to 1 percent. President Bullard believes that to maintain credibility, the Committee must defend its inflation target when inflation is below target as well as when it is above target.
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> President Bullard also felt that the Committee's decision to authorize the Chairman to lay out a more elaborate plan for reducing the pace of asset purchases was inappropriately timed. The Committee was, through the Summary of Economic Projections process, marking down its assessment of both real GDP growth and inflation for 2013, and yet simultaneously announcing that less accommodative policy may be in store. President Bullard felt that a more prudent approach would be to wait for more tangible signs that the economy was strengthening and that inflation was on a path to return toward target before making such an announcement.
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> In addition, President Bullard felt that the Committee's decision to authorize the Chairman to make an announcement of an approximate timeline for reducing the pace of asset purchases to zero was a step away from state-contingent monetary policy…

We concur with Bullard that deflationary risks continue to outweigh inflationary risks. The actual FOMC statement noted that recent inflation readings have been below the target range, but somewhat curtly ascribed these readings to "transitory influences."

Markets were anxious in anticipation of the FOMC meeting, particularly as a result of the May 22 Congressional testimony in which Bernanke addressed questions surrounding the timing and conditions for tapering. In spite of what we view as a series of more dovish than hawkish messages, the markets clearly focused on the timeline provided by Bernanke in his press conference for the end of asset purchases by 2014. The ensuing sell-off in bonds globally was particularly severe. While US 5- and 10-year Treasury yields rose over 50 bps, peripheral yields in Europe spiked even more, with Portuguese 10-year yields 80 bps higher, and Greek 10-year yields rising over 100 bps. Emerging-market yields also spiked. At the same time, equity prices slid globally. As was the case in the bond markets, the US equity market declined less than global peers did, with the S&P 500 Index down just over 4%, while the MSCI Emerging Market Index fell 7% and the MSCI EMU Index declined 8%. It is no surprise that markets sold off, though some investors might have been surprised that the non-US sell-off was so much more severe. We view the United States' relative resilience as indicative of the better underlying economic conditions, and global recognition that the Fed can choose to continue its easy money policies if the economy weakens (which is comforting) or can begin easing off the accelerator if the economy continues to strengthen (which is also positive). Put simply, we believe investors have realized that the Fed has navigated the crisis well and is effectively in the driver's seat when it comes to global monetary policy.

So, what is our base-case scenario for the end of QE?

We always consider a range of scenarios when we decide whether to commit capital to an investment idea. These scenarios, where appropriate, can take into account policy decisions such as when and how to end QE. We are highly unlikely to position a portfolio to be susceptible to a single macroeconomic or political outcome. Rather, we are more likely to avoid ideas that might be significantly impaired in such a case. Our primary objective in every decision is to identify the investments with the best combination of risk and reward under a range of potential economic, political, and regulatory backdrops.

Given that understanding, our current view is that the Fed is unlikely to ease off the accelerator or use the brakes as aggressively as the market reaction this month would imply. The primary basis for this view is a combination of the background points noted above, and our view that there is a self-governing feedback loop in the US economy. Essentially, higher rates would undermine some of the logic for tapping the monetary brakes. One reason why economic optimism in the United States has improved so substantially is the improved housing market and the fact that US consumers have decreased their debt from 98% to 80% of GDP in the last four years. As a result of the deleveraging, along with record-low interest rates, debt servicing burdens are at a 28-year low for US consumers. Were the Fed to begin reducing monetary stimulus, causing interest rates to increase from abnormally low levels, the debt service burden would increase, as would the cost of purchasing a home for any buyer who requires financing. In fact, the rate for 30-year fixed-rate mortgages has already increased by more than 50 bps to over 4.50% rather quickly. Compared to the mortgage rate of 3.50% as recently as last May, servicing a mortgage at 4.50% would cost 13% more per month.

To the extent house price appreciation slows or even stalls, our economic optimism would be substantially reduced. We have noted in the past that the primary residence comprises over 60% of the typical middle class household's assets (as of 2010). House prices on a national basis only began to rise in early 2012, and the process for consumers to realize that home prices have risen takes time. Very few Americans have heard of the S&P/Case-Shiller 20-City Home Price Index, much less monitor it regularly. Instead, most Americans learn about house price activity anecdotally from word of mouth or seeing a neighbor list and sell a home. Thus, the translation of house price improvement into consumer confidence, spending, and investment decisions, is delayed. We believe attitudes within the household are just beginning to change as a result of house price increases, and believe there is still some fragility to the budding confidence.

Given the delicate balance that remains between the large amounts of household debt and higher interest rates, we believe that any major increase in rates would likely lead to less pressure on the Fed to reduce its stimulative policies. We believe the Fed is aware of this feedback loop, and consequently is facing a tough decision about how long it can wait to remove stimulative policies. The Fed certainly does not want to begin tightening, only to then have to reverse course, creating more volatility and uncertainty in the process.

We recognize that the Fed will inevitably have to normalize policy. While the normalization process might not be smooth or elegant, there are a lot of ways for the Fed to incrementally adjust policy. Even the Fed's communication has been a beginning to the normalization, as it alerts investors that change is coming. As previously discussed, it also gives the Fed a chance to see where excesses might have arisen in markets from its exceptional policy to date.

As we look forward, we think of normalization as a multi-step process. Some steps are actually more gradations of change, but it is important to recognize that the Fed has effectively been writing a new playbook through this crisis, and will be extraordinarily careful exiting its policies to ensure it does not create another crisis. The steps we expect the Fed to take within our base-case scenario (with a corresponding, estimated timeline) follow:

1. Already accomplished: Start talking about tapering and provide guideposts that inform investors of the potential catalysts that would cause the Fed to consider policy changes. Note that we said *consider* policy changes rather than make them. The goal is to psychologically prepare people for change and then give markets time to adjust rather than be surprised.

2. Late 2013 to Early 2014: Start decreasing the size of net securities purchases. Given the feedback loop discussed above, we believe the Fed's statements in recent weeks alone have decreased the stimulative effect of monetary policy and will decelerate growth, effectively mitigating and delaying the need to reduce the stimulus. Thus, we expect this later than the Fed has indicated.

3. Mid-to-Late 2014: Stop net purchases but continue gross purchases of securities to maintain the size of the Fed's portfolio by reinvesting proceeds from bond maturities. This is later than the guidance provided by Bernanke, reflective of our continued expectation of a relatively muted economic growth trajectory.

4. Late 2014 to Early 2015: Allow securities to mature to begin reducing holdings on the Fed's balance sheet. The Fed might continue to buy some bonds to stabilize markets, but will allow run-off to accelerate over time.

5. Early-to-Mid 2015: Cease all security purchases and allow the bond portfolio to begin running off more rapidly.

6. Mid-to-Late 2015: Raise the interest rate paid on excess reserves held by banks at the Fed to decrease the supply of credit in the markets. Bernanke indicated in his May 22 testimony to Congress that this is the first tool the Fed will use to apply the brakes on monetary policy after it ceases asset purchases. We have not seen it used before, so it will be an interesting test.

   Perhaps around this same time, the Fed might begin to sell securities that are not MBSs, but where maturities have left insignificant holdings and/or where market depth is sufficient to absorb the bonds without creating disruption to end borrowers.

7. Late 2015 to Early 2016: Raise the federal funds target rate incrementally to begin the process of applying brakes to economic growth.

All along this theoretical scenario timeline, we expect the Fed to carefully monitor both unemployment and inflation rates in keeping with the dual mandate. In light of the structural reforms under way in parts of Europe and soon in Japan, not to mention the weakening of the yen and its impact on export prices, we would continue to carefully monitor inflation rates in particular. St. Louis Fed President Bullard might be early or a bit excessive in his concerns, but we believe his points are legitimate. If inflation continues declining, we would expect this timeline to be extended further as the Fed focuses more on the inflation aspect of its mandate than the unemployment factor.

What do the Fed's moves mean for markets?

The immediate reaction to the FOMC announcements was extreme, in our view, as it should be clear to all investors that the current monetary policies cannot last forever. When evaluating different securities it is critical to understand the upside and downside potential of such changes, as well as the timing in which such events are likely to occur. For example, it is clear that some firms have enormous leverage to higher rates. In some cases, earnings could double or perhaps even triple if the federal funds target rate were 3.00% or higher. However, given the timeline above, we would not expect such a level in our base-case scenario until perhaps 2017 or 2018.

Other potential beneficiaries include a host of companies with net cash on their balance sheets. These companies include many in the technology industry, as well as those that hold cash on behalf of clients and earn the float. We would expect a gradual rise in interest rates to benefit the insurance industry, which has been hurt by record-low reinvestment rates for maturing securities and investments, and has struggled to cover prior commitments to policyholders. We also expect some banks to benefit over time, but not uniformly.

Those who would likely lose out in the case of eventual rate normalization include companies that have benefited from investors' desperate search for yield. Real estate investment trusts (REITs) and utilities companies are obvious examples. However, over the last few quarters we have observed that companies with stable, but in many cases middling, returns on equity have reached unprecedented valuation levels as investors sought "safe" investments. We believe there is nothing safe about overpaying for an asset. The last notable set that would be hurt are highly indebted companies. We have long believed highly leveraged companies face greater risks than those with strong balance sheets, but the easy money policies have continuously benefited borrowers by allowing them to refinance at lower rates and decrease their interest expense. This financial management rather than operational performance can only go so far, and we believe we are at that point.

Our philosophy and process have not changed. We continue to seek the best investment ideas on a company-by-company basis, evaluating the various scenarios that apply to each. The monetary policy environment, on the other hand, might have already begun to change. We believe such a change, when it does occur, should be favorable for our investment style, as we have long avoided excessively leveraged companies in favor of those with strong balance sheets. We also believe that this new environment is likely to be one characterized less by high correlations and what people have described as the risk-on, risk-off psychology in recent years. While we have a longer expected timeline for interest rate normalization, it is clear that, in terms of QE, the Fed is signaling the beginning of the end.