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The QE3 Conundrum:
The Benefits of (and Limits to) Monetary Policy

Fixed Income Market Outlook

Highlights

- While we've seen risk assets head higher on the back of monetary policy expectations (and recent announcements), there has simultaneously been a continued deceleration in global growth.
- The recent aggressive policy moves by ECB president Mario Draghi should go some distance toward mitigating systemic risk in Europe, as it helps with peripheral market refinancing ability.
- Likewise, the Fed's recent announcement of QE3 has cut left-tail risk considerably, but whether it can succeed in its goal of meaningful labor market improvement remains in doubt.

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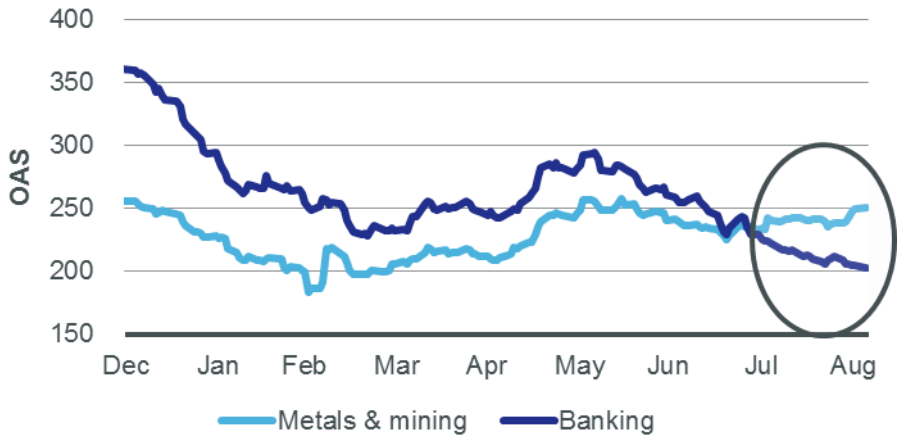
Despite a Backdrop of Decelerating Global Growth, Risk Assets Tell a Different Story

Market price movements can have interesting stories to tell us, and while those tales are often complicated, or require qualifications, they can also help point toward the direction our narrative may head next. With that in mind, what should we make of the fact that (as of this writing) the S&P 500 Index of large-cap US equities has increased more than 18% so far this year, and risk assets of all kinds are on pace to make 2012 one of the strongest returning years in a decade? At the same time, we've seen equity market volatility levels, as measured by the Chicago Board Options Exchange VIX Index (on the S&P 500), trend downward this year to the point where the VIX now resides more than 25% lower than its long-run average level. And both these market movements have come in the course of a year that unarguably held a tremendous number of potential left-tail risk

Figure 1: Metals and Mining vs. Banking Sector Spreads in 2012 (bps)



Source: Peterson Foundation, Nomura Global Economics

The views expressed are those of Rick Rieder, Chief Investment Officer of Fixed Income, Fundamental Portfolios as of September 2012 and may change as subsequent conditions vary.

events along the way. The answer to this question, in our view, is that the expectations for, and recent announcements of, further quantitative easing in Europe and the United States have meaningfully reduced the risk of potential systemic shocks in the context of fragile economies.

As we have described many times in the past, we now live in a period of financial repression when real interest rates are likely to remain extraordinarily low for a long period and when economic growth rates are also likely to be muted. In this context, we have argued, investors will have to learn how to navigate shorter economic and market cycles, and for the foreseeable future, market movements are likely to be considerably influenced by monetary policy rather than by idiosyncratic fundamental factors. We have seen a good illustration of this dynamic recently, as a great deal of this year's impressive total returns in a variety of risk assets has come in short bursts over the past four months, as policy anticipation built ever higher. In our view, what we have seen over this time is the revaluation of all financial assets on the back of systemic risk mitigation (largely Europe-related) stemming from ever more aggressive monetary policy.

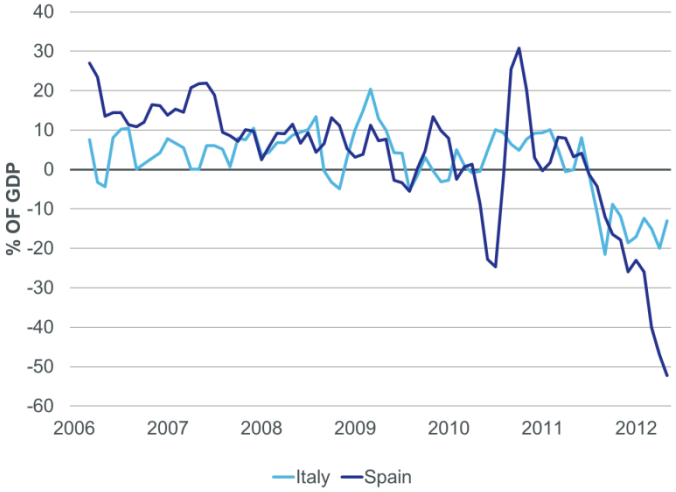
We can also witness this dynamic at play in specific industry equity market movements. For example, if we use metals and mining sector equity prices as a proxy for global economic growth and financial sector equity price levels as a proxy for systemic risk fears (admittedly an imperfect exercise), we can see that growth and systemic risk were highly correlated in 2011 in a manner that implied that high levels of systemic risk meant low growth and vice versa. However, in 2012 we have seen this relationship break down, and looking across the capital structure, we also see this relationship shifting in fixed income markets too. Thus, when comparing the option-adjusted spread to Treasuries of metals and mining and financial sector issues, we can see that since mid-year investment-grade credit market participants have been more comfortable underwriting systemic risk than they are underwriting risks to growth (see Figure 1). Put another way, financial sector debt has seen a tremendous re-pricing of the systemic risk premium that had heretofore been embedded in its yield spread over Treasuries.

Interestingly, the market movements described above come directly alongside the deterioration of economic growth prospects across the globe. In recent months the Eurozone has run headlong into a likely recession, growth in the US has remained anemic, and a slowdown in China's growth has been the cause of great consternation among market observers. Globally, many Purchasing Manager Index levels that gage the strength of a country's manufacturing sector have slipped below the critical 50-point mark, indicating contraction in these sectors. That trend appears most pronounced in the Eurozone, where average PMI levels have settled at 45 recently, and where the absence of stronger credit creation has hampered economic recovery. Moreover, since European banking institutions are significant players in financing global trade with developing markets, weak credit creation there also contributes to the emerging market slowdown. We are concerned about this slowing growth, and particularly that in China, where foreign direct investment has declined and real GDP growth has markedly slowed. Still, we do not believe that China's slowing growth represents a tangible risk of greater systemic shock, as the country holds considerable flexibility in its policy options for maintaining growth and has a great incentive to do so since it is on the eve of an important leadership transition.

Monetary Policy to the Rescue: Mario Draghi's Aggressive Moves

As we argued in July, the Eurozone faces several longer-term (structural) challenges to its growth, but regarding the immediate problem of its sovereign debt and banking crisis the obstacles are clear. Through much of this year, an accelerating capital flight from more peripheral economies (including Italy and Spain) toward core country banking systems led to heightened levels of systemic risk and further financial imbalances (see Figure 2). As we highlighted last month, the relative shortage of sound collateral in the Eurozone banking system both created a daunting depiction of an unstable system, and also placed a near freeze on potential credit creation, which as we've long argued, is vital for sustaining economic recovery. We believe there is a broad recognition now that core country interest rates are "too low," as peripheral rates were prohibitively high, which is suggestive of a broken financial system in the region. Fortunately, Mario Draghi and the ECB have aggressively stepped in with monetary accommodations that should help further normalize rates in the region (marginally higher core rates that converge with reductions in peripheral country rate levels), which, in turn, may actually help promote credit creation and growth.

Figure 2: Capital Flight Seen in Portfolio/Other Flows (central bank flow adjusted, 3 month sum)



Source: Nomura, Bloomberg

To recap the details of the plan: beyond maintaining its benchmark interest rate at 0.75% (and keeping deposit and marginal lending rates stable), the ECB's Governing Council announced the formation of a new sovereign debt purchase program (Outright Monetary Transactions, or OMT) and it further relaxed its collateral rules. The bond-buying program will focus on the 1-year to 3-year segment of the yield curve and the purchasing will be sterilized, which is an attempt at avoiding any overly inflationary outcomes down the road. The OMT does not have a pre-determined size, and in an effort to assuage concerns from private market participants, its holdings will not be deemed senior to private creditors, but rather will be *pari passu*. Finally, some amount of conditionality would be imposed on participant countries to help achieve a greater degree of fiscal budgetary discipline. The fact that the bond purchase program will impose conditionality on a participating country, it should be noted, is an important differentiating characteristic to QE programs undertaken in the US, which do not have to deal with these constraints, making them more flexible.

With regard to ECB collateral rule changes, we have already quipped in the past that the ECB was rapidly approaching the point when it might announce that "a used bus ticket isn't eligible for repo," in an effort to maintain some standards, but truly the rules governing the collateral the central bank will accept have become remarkably lax. For instance, the ECB has effectively suspended the minimum credit rating requirement for many types of collateral. Moreover, the central bank will also now accept non-euro denominated debt securities as collateral, all in the attempt to ensure that collateral shortages are mitigated in the Eurozone banking system. In the end, perhaps we may begin to see a reversal in the capital flow trends discussed above. That eventuality, should it occur, could go some distance toward restoring confidence in the region's stability, thereby bringing private capital back in a meaningful way.

Monetary Policy to the Rescue: Ben Bernanke's QE3 Conundrum

The initial shock of the global financial crisis on economies worldwide forced central banks into taking dramatic action in 2008, and of course, high degrees of monetary accommodation have been part of our economic and investment landscape ever since. The extent of balance sheet expansion has been extraordinary. To that end, on September 13 Bernanke's Federal Open Market Committee announced yet another round of quantitative easing. This time the purchasing will be open-ended, and it will specifically target labor market improvement. The statement read: "The Committee will closely monitor incoming information on economic and financial developments in coming months. If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability." To attempt to achieve these ends, the Fed will purchase $40 billion/month in agency mortgage-backed securities, it will continue reinvesting principal payments from its agency MBS portfolio into that market, and it will maintain its "Operation Twist" maturity extension program through year-end. Further, the FOMC states that its benchmark fed funds policy rate will remain at very low levels "at least through mid-2015."

This Fed policy move is not only extraordinary for the extent to which it will impact market technicals, as for example, the specifically described MBS purchases alone will take out more than half of all new MBS originations, but also for the degree that the Fed has used more aggressive communications as part of its approach to influence market participant expectations. Still, we find it interesting that the Fed has chosen to specifically target an economic metric it can't directly control, that of labor market improvement, and this, in turn, suggests to us that financial repression may be with us for a very long time. Moreover, despite the recent spike in breakeven inflation rates, with velocity of money still trending down, we have yet to see any heightened realized inflation resulting from quantitative easing. That fact has given central banks on both sides of the Atlantic a freer hand to maneuver. Additionally, while velocity of money appears anemic in the US today, overall corporate and consumer deleveraging has occurred to a significant degree, such that modest credit creation improvement could be at hand. And since bank capitalization levels have improved markedly, we would argue that sustained growth in credit creation must come from demand for credit from borrowers, and not from added liquidity. Still, the question facing investors today is, will another round of monetary liquidity improve the real economy, or will it merely inflate financial asset prices?

These recent actions also make it clear that supporting the nascent housing recovery is a priority for the Fed, as much of the asset purchasing activity over the next several months will focus on aiding mortgage markets. We also believe that the housing sector is on the mend, but we would argue that its upward trajectory will not be terribly dramatic and that it is unlikely to be able to stimulate broad-based economic growth. It also appears likely that both investor and homebuilder sentiment on the strength of the recovery in housing may have gotten ahead of itself. For instance, while we've seen some improvement in housing market index and housing starts data (see Figure 3), much of that gain can be ascribed to multi-family starts, rather than single-family residential construction. Also, the homeownership rate continues to decline toward its longer-term norm, and credit quality standards have increased meaningfully for mortgage financing, suggesting that there are still quite a few families that are likely to be shifting from the owner to renter categories and that many still may find obtaining a mortgage challenging. Further, near historically high foreclosure inventory levels are likely to weigh on the market for some time, and while housing price declines have improved affordability, low rates of income growth also do not bode well for a more rapid recovery. Thus, while we are witnessing a stabilization and improvement in housing, the pace of that gain likely will not be improved by lower mortgage rates resulting from added Fed purchasing in the mortgage market. And if housing improvement is difficult to

effectuate via the blunt tools available to policy makers, we would argue that producing meaningful gains in structurally challenged labor markets may prove an even greater hurdle.

Figure 3: NAHB Housing Market Index Level vs. Housing Starts (in 1,000s)

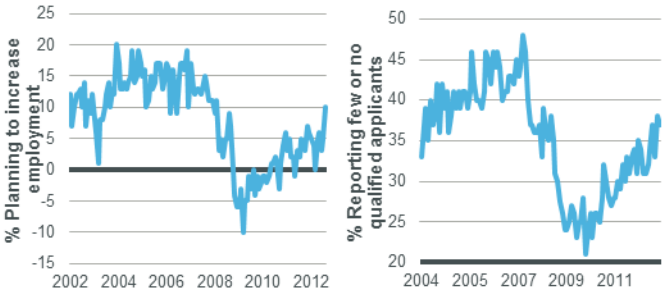
Source: National Association of Home Builders, Census Bureau

QE3, Labor Market Recovery, and Financial Asset Inflation

We have long argued that the struggles witnessed in labor markets today are structural in nature, and do not merely represent those of a typical cyclical downturn. In our view, the evidence for this position abounds. For example, broad-based metrics gaging the health of labor markets, such as the employment/population ratio, or the labor force participation rate, have either flat-lined at depressed levels, or are still trending downward (respectively), underscoring the unusual character of this labor market weakness. Moreover, labor market recovery in what we suggest are structurally impaired sectors of the economy (i.e. real estate, finance, manufacturing, government) have been slow to come back, or have continued to deteriorate, and it is likely that many of these jobs will not come back in the foreseeable future. Furthermore, since the non-structurally impaired sectors of the economy have seen a significant rebound from their recession nadir (with roughly four million jobs recovered), it is unclear whether this segment of the labor force will be able to aid meaningfully in reducing the unemployment rate further anytime soon. Ultimately, what will be required to see a more meaningful labor market recovery is education, retraining, and geographic relocation, to shift significant numbers of unemployed (and under-employed) workers away from structurally impaired segments of the economy to those areas in which they can be more productively utilized. This process, however, will take a great deal of time, it will require well-designed fiscal initiatives (such as research and development tax credits, capital expenditure incentives, small business lending programs) to be married to monetary policy, and it would benefit from greater regulatory and policy certainty to boost business confidence. Overall, in our view, monetary policy accommodation alone is not likely to have more than a marginally positive impact on unemployment going forward.

This thesis is also supported by examining a series of other labor market trends: such as job openings versus youth labor participation, small business survey data, and the productivity gains realized in recent years due to technological innovations. While job openings have been trending higher since the recession's end, the labor force participation rates among younger workers (those 20 to 34) has remained at remarkably depressed levels. At the same time, small business survey data from the National Federation of Independent Businesses suggests that business owners have wanted to grow their payrolls, but they have increasingly reported a dearth of qualified applicants (see Figure 4). Taken together, these data points suggest that there are indeed structural mismatches in labor market resources that need to be worked out. Added to this is the fact that employee benefit costs continue to grow faster than wages, and many firms have found that they can boost productivity through technology without adding to headcount. In fact, the revolutions witnessed in personal computing, database construction, and the Internet over the past couple decades are having a profoundly transformative (if sometimes underappreciated) impact on labor markets today. In the pre-Internet era, there was a positive correlation between productivity gains and growth and hiring, but now that relationship is negative. Astoundingly, increased productivity today (via technology) appears to mean the creation of fewer jobs, and while the jobs that are created by technology companies (or those that utilize technology) may be high skilled and high-wage, there are strong arguments to suggest that many more jobs are displaced due to this dynamic.

Figure 4: Recent NFIB Small Business Survey Results Illustrate Structural Challenges to Employment



Source: Haver Analytics

Fed Chairman Bernanke's conundrum, then, is that while he attempts to meet the central banks' dual mandate of full employment and price stability, neither of these goals are being adequately achieved, and as we have argued it may prove exceedingly difficult to positively impact labor markets through further monetary accommodation. Our concern, however, is that continued financial asset price distortions, and possible elevated future inflation, may well turn out to be costs that are too high to pay, given the modest benefits we expect from QE3. In this context, we expect left-tail risk and volatility to remain in check, while risk assets should inflate further, risk-free curves should

steepen (however, in Europe, we may see yield curves bull-flatten), and inflation expectations may rise along the curve. Strong demand for yielding assets (and modest supply) will continue driving the “structural bid for yield” we have often described, and while policy will impact markets dramatically its impact on the real economy is likely to be more modest.

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