U.S. Retail

Allianz Global Investors

Understand. Act.

QE3 Staves Off Recession, Not Repression

9/14/2012

Our investment experts break down the Fed's announcement of another round of quantitative easing, what it means for markets, the economy and corporate earnings and how investors can best position their portfolios.

Andreas Utermann
Global CIO
Allianz Global Investors

Scott Migliori
CIO, U.S.
Allianz Global Investors

Ben Fischer
Founder, CIO
NFJ

Rob Parenteau
Economist, Allianz Global Investors

When investors needed a confidence boost most, the Federal Reserve didn't disappoint.

Fed Chairman Ben Bernanke announced a third round of quantitative easing, or QE3, Thursday in an effort to jumpstart the economy and get more Americans back to work. The move, the result of a two-day Federal Open Market Committee meeting, comes on the heels of a string of lackluster jobs reports, weakening manufacturing activity and deteriorating earnings estimates. It also follows the European Central Bank's unveiling of an unlimited bond-buying program and ECB President Mario Draghi's pledge to do "whatever it takes" to save the euro.

In both its actions and words, the Fed seemed prepared to use the full heft of its resources to quicken the pace of the recovery. "The Fed is throwing the kitchen sink at the problem," says Andreas Utermann, global chief investment officer at Allianz Global Investors. "We're seeing further manipulation of the bond-yield curve in an attempt to generate liquidity."

A New Twist
What was unusual, however, was the flexible nature of the Fed's plan. Unlike previous rounds of stimulus that called for a specific lump sum over a set period of time, there was no timeline or total dollar amount given for QE3. Rather, Bernanke said the Fed will purchase $40 billion worth of mortgage-backed securities each month for as long as it takes. By leaving it open-ended, the Fed has a lot of discretion to step it up over time. In addition, it plans to keep the federal funds target interest rate at 0 to .25% until at least mid-2015.

In tandem, the one-two punch of the Fed and the ECB goes a long way toward keeping the economy from going into a tailspin. "The good news is that we won't have a recession in 2013," says Ben Fischer, chief investment officer and portfolio manager at NFJ Investment Group.

Stocks rallied on the news as good vibes that central bankers have a handle on economic challenges reverberated through financial markets. While much of the Fed move was already priced in, Bernanke delivered a little more firepower than initially thought. "It's a little bit better than we expected," says Rob Parenteau, economist at Allianz Global Investors. "We anticipated $30 billion to $60 billion a month and we got $40 billion a month plus room for expanding that amount based on economic conditions."

Work in Progress?
The overarching theme of the Fed's message was a commitment to help get people back into the workforce, a focus that peppered Bernanke's remarks. "This is a Main Street policy. We're trying to get people working again," Bernanke told reporters. It was unprecedented—at least in the modern era—to hear the Fed be so explicit about policy being so closely linked to labor-market conditions. And one or two months of improvement won't pass muster. "We're not going to be looking for little wiggles in the numbers…to cause us to radically shift our policy," Bernanke said.

Its unconventional monetary policy notwithstanding, the Fed has a lot of heavy lifting to do. "Everything now hinges on employment," Parenteau says. "We probably have to get through the 7% to 7.5% threshold in unemployment before the Fed can call off QE3."

Still, with such a large dose of mortgage-backed securities purchases, it's clear that policy makers are trying to build off the momentum we've seen in housing and encourage consumer spending by pushing interest rates lower. And despite paltry yields on CDs and Treasuries, low interest rates support many other assets Americans own, such as homes and businesses. "Healthy investment returns could not be sustained in a weak economy and, of course, it's difficult to save for retirement or [meet] other goals without the income from a job," Bernanke said. "Thus, while low interest rates do impose some costs, Americans will ultimately benefit most from the healthy and growing economy that low interest rates help promote." The upshot: Attractive refinancing options and more disposable income to purchase big-ticket items will juice the economy.

QE3 vs. Earnings
Perhaps the most telling sign of the Fed's success in steering market sentiment in the near term will be how it stacks up against a difficult third-quarter earnings season, according to Scott Migliori, chief investment officer of RCM/AGI U.S. "Corporate profits have held up reasonably well but we're starting to see some erosion, especially on the top line," he says. Indeed,

consensus S&P 500 2012 earnings expectations have recently hit their lowest level in more than a year, ratcheted down to $103 per share from $110 per share just four months ago. And only 40% of S&P 500 companies have beaten revenue estimates. Meanwhile, the ISM Manufacturing Index has been below 50 for three straight months. The price of oil has also spiked to nearly $100—approaching its 2012 high—which could dampen any GDP expansion.

Despite this economic contraction, QE3 should prove sufficient in counterbalancing the erosion of such fundamentals. "We anticipate that the Fed's actions will result in lower long-term interest rates, higher equity prices and a lower dollar," Migliori says. With that kind of backdrop, companies can earn and consumers can spend.

Still, it's way too early in the game to chalk it up as a victory. "In order for the Fed's plan to work, we're relying on two unspoken aspects: a weaker dollar boosting U.S. exports and higher equity prices, which encourage companies to spend more of their profits," says Utermann. Further, there are a series of headwinds stoking volatility including the euro-zone crisis, the U.S. fiscal cliff, oil prices potentially overheating and China's cooling economy.

Coping with Financial Repression
"The macro picture hasn't changed—it's been reaffirmed," Utermann says. "We're in an environment of financial repression." What that means is low growth and low interest rates, and the likelihood that the real value of people's investments slips into negative territory. By sitting in cash or Treasuries and avoiding risk assets altogether, investors lose without ever stepping foot on the pitch.

So how can investors combat the ill effects of negative real yields? By taking what the market gives them and being selective within those segments. Dividend-paying stocks, small caps and Asian currencies, for example, are asset classes that are poised to outperform, based on recommendations made at our June AllianzGI Investment Forum in Hong Kong. "We have a very staunch belief that we're being forced to take risk to get income," NFJ's Fischer says. "This leads you, inevitably, to high-quality, dividend-paying stocks." From an individual sector standpoint, he sees cyclical stocks, commodity stocks and commodities benefiting from QE3.

Utermann echoes this sentiment: "Investors should look to invest in companies with strong global franchises and high, sustainable dividend yields."

A Word About Risk: Equities have tended to be volatile and, unlike U.S. Treasuries, do not offer a fixed rate of return. Foreign markets may be more volatile, less liquid, less transparent and subject to less oversight, and values may fluctuate with currency exchange rates; these risks may be greater in emerging markets. Dividend paying stocks are not guaranteed to pay dividends. Investments in smaller companies may be more volatile and less liquid than investments in larger companies. Bond prices will normally decline as interest rates rise and can fluctuate due to the credit risk of the issuer. Investments in commodities may be affected by overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes and international economic and political developments.

The material contains the current opinions of the author, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities. Forecasts and estimates have certain inherent limitations, and are not intended to be relied upon as advice or interpreted as a recommendation.

Allianz Global Investors Distributors LLC, 1633 Broadway, New York, NY 10019-7585, www.allianzinvestors.com, 1-800-926-4456.

AGI-2012-09-14-4670