The Washington Whale

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"It does seem to me, that herein we see the rare virtue of a strong individual vitality, and the rare virtue of thick walls, and the rare virtue of interior spaciousness. Oh, man! admire and model thyself after the whale! Do thou, too, remain warm among ice. Do thou, too, live in this world without being of it. Be cool at the equator; keep thy blood fluid at the Pole. Like the great dome of St. Peter's, and like the great whale, retain, O man! in all seasons a temperature of thine own."

–Ishmael, Moby Dick narrator's advice to Federal Reserve Chairmen… and investors

The Washington Whale: Quantitative Easing and the Global Financial Markets

The Federal Reserve's strategy for stimulating growth, employment, and price stability by buying assets (otherwise known as Quantitative Easing) remains in full effect. Our view is that the sheer size of this program remains the dominant factor in evaluating financial markets. Below we discuss the size of this program relative to the overall growth of global financial markets (i.e. stocks, bonds, loans).

Financial markets grow for two primary reasons – 1) the net supply of assets increase, or 2) prices increase on average. The supply of assets grows when debt or equity is issued by an entity that wants to raise money. Prices increase when buyers outnumber sellers – or more precisely when total buyer interest exceeds seller interest. The money from Quantitative Easing is used to buy Treasury and mortgage-backed bonds here in the United States. Money from the Federal Reserve is akin to a new buyer entering the market.

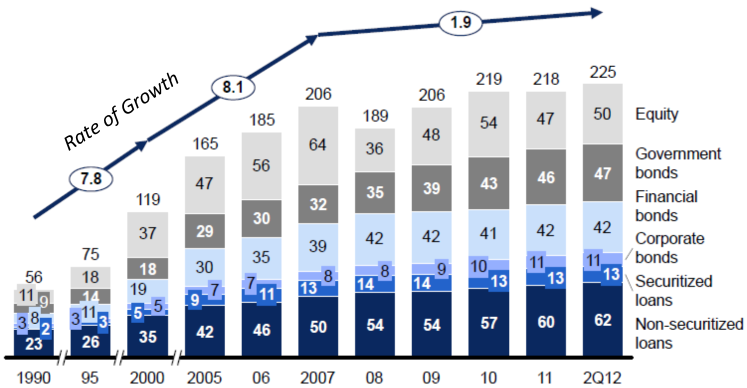
As a result, Quantitative Easing has a direct impact on the asset prices of bonds. This new money, provided to those who sell to the Federal Reserve is, in turn, used to buy other assets – impacting prices beyond bonds.

The Size of Global Financial Markets

The size of global financial markets stands at approximately $225 trillion according to consultant McKinsey & Co[i ii]. This encompasses 183 countries, and a broad set of financial vehicles (stocks, bonds, and loans collectively). The United States is the largest player, making up approximately 30% of these assets. Over the past several years, **these markets have grown at a rate of just over $8.5 trillion per year** ($60 trillion since 2007).

Global Stock of Debt and Equity Outstanding

$trillion, end of period, constant 2011 exchange rates



Source: McKinsey & Co.

The Size of Quantitative Easing

New money from the Federal Reserve's Quantitative Easing program comes to the tune of $85 billion per month; or a staggering **$1.0 trillion per year**.

Consequently, this new money from the Federal Reserve represents approximately 10% of the growth in global financial markets. Within the United States, Quantitative Easing likely represents more than 25% of the recent growth in domestic financial markets via upward price pressure.

It's hard to say exactly what the impact of Quantitative Easing is on financial markets, but it's not too different than a large whale entering a pool stocked full of smaller fish – as it enters, the water level rises. For the water level to return to its former level, many fish would have to leave. Likewise, it's hard to imagine the number of sellers required to offset the impact of the Washington Whale. This is a significant factor in our view that short-term pullbacks in asset prices remain opportunistic while Quantitative Easing is in effect, at least in the U.S.

Three Big Concerns

As Quantitative Easing draws closer to its past-due date, do the assets that have benefitted from the program face the risk of price corrections given the loss of new inflows from the Whale? Specifically:

1) Will economic growth be healthy as Quantitative Easing tapers (will the Whale gracefully complete its entry into the pool)?
2) Will the Federal Reserve eventually "unwind" by selling (how does the Whale leave the pool)?
3) Are there any significant pockets of overvaluation (has the Whale caused the pool to overflow)?

While each of these questions can be thoroughly debated, we remain moderately optimistic.

For the first question, Chairman Bernanke, and his presumed successor Ms. Yellen, give every indication that they remain in favor of a data dependent approach to Quantitative Easing – namely that in order to begin tapering, employment needs to be robust and consumer prices are not at risk of deflation or disinflation. Most signs of economic growth are mildly positive, but far from "overheating." As a result, Quantitative Easing looks to be part of the equation until a time when economic growth is more robust.

Regarding the second question of unwinding, the major concern is what happens if the Federal Reserve becomes a major seller of assets (as opposed to its current incarnation of a buyer)? Of course, this is possible, and it would have a negative affect on asset prices. However, this seems unlikely. For Quantitative Easing, the Federal Reserve essentially creates money out of thin air by simultaneously buying bonds in the open market and electronically crediting funds to the reserve accounts of its corresponding primary dealer (it works with 21 banks and brokerages for Quantitative Easing). For unwinding, the Federal Reserve could reverse the procedure by selling assets, which would put pressure on asset prices. Alternatively, it could simply allow bonds to mature. By taking the second approach, as assets mature, the Federal Reserve offsets the proceeds by electronically reducing the reserve account at the corresponding primary dealer; thereby gradually unwinding without selling.

For the remainder of this update, we consider the third concern – has the Whale caused the pool to overflow (i.e. asset bubbles)?

Interest Rates & Fixed-Income

Since the Federal Reserve has been buying bonds, there is concern that there may be a bond bubble. When the bond market falters, interest rates rise and bond prices fall. Interest rates rise for several reasons. Three primary reasons are:

1) Investors are concerned about defaults or liquidity
2) Investors are concerned about inflation
3) The Federal Reserve wants to slow things down

In 2008, corporate bonds had negative returns while Treasury bonds had positive returns. This exemplifies the first reason listed above – default and liquidity concerns – because corporate bonds have a risk of defaulting on interest payments and Treasury bonds do not (historically, that is). Today, most investors do not seem too concerned about defaults. Nor do investors seem overly concerned by inflation (the second reason) as indicated by the prices of Treasury Inflation-Protected Securities (aka TIPS).

Despite this, we have seen rates rise over the past few months – putting pressure on bond prices. Much of this has to do with the last reason in the form of Federal Reserve messaging. In May, messaging implied that tapering would begin in September (meaning less bond buying). Despite the Federal Reserve's actual continuation of bond purchases via Quantitative Easing, its messaging stimulated sellers to overwhelm the bond market – reallocating to places like equities and cash.

Once September arrived, the Federal Reserve changed its message back to status quo – 'Damn the torpedoes, full Quantitative Easing ahead!' Nevertheless, Quantitative Easing is a policy tool, and we must consider its eventual end.

Absent Quantitative Easing, it's reasonable to envision a scenario where interest rates rise to more normal levels. What is a normal level? Our view is that risk-free interest rates (i.e. Treasury bonds) naturally gravitate towards some level above inflation. For 10-year Treasury bonds, 2.5% over inflation would not be unreasonable – and is in fact quite normal. Given current levels of 2.7% on 10-year

Treasury bonds and 1.5% for inflation, an 80 basis point increase in rates would not surprise us as the Federal Reserve reduces its Quantitative Easing program.

Consequently, we remain cautious on excessive risk-taking on interest rates (i.e. long-term bonds), while optimistic on credit and alternate forms of fixed-income investing.

Equity Markets

We believe Quantitative Easing has indirectly benefitted the equity markets, which are up a handsome 20% so far in 2013 (as of September 30 for the S&P 500). As Quantitative Easing eventually comes to an end, we don't see the Federal Reserve as a major seller. However, they will not be the major buyer they were in 2013, either. As a result, as the program's end draw nigh, investors will likely react in caution. The question remains, if there is a pullback, would it be shorter or longer term in nature?

Since the revenues and earnings of businesses tend to grow over time, stock prices grow as well. A long-term bet against stocks is a long-term bet against business. Likewise, long-term bearish prognosticators are great at tapping into investor fears, but seem to be wrong more than right. In other words, the house wins in the long-run. In our view, the notion that businesses grow and pay a portion of earnings to owners is why maintaining a long-term "strategic" allocation to equities is appropriate for most investors.

On the other hand, over shorter periods of time, the rise and fall of stock prices is the result of any number of factors such as valuation or the end of Quantitative Easing. These risks encourage "tactical" asset allocation changes to investor portfolios. The challenge is that prophesying shorter term stock market movements often overwhelms the primary strategic purpose of investing in stocks; that businesses grow and pay dividends. In other words, you are betting against the house when you are negative. Regardless, let's consider three threats to stock prices:

Valuations

There seems to be a healthy amount of concern related to fundamental valuations - namely that stock prices have outgrown their worth. There are numerous measures to study valuations. Many bearish strategists have lately latched on the idea that margins are high and growth is slowing. The rationale goes, earnings growth will slow (or decline) and prices will fall. This is reasonable until you consider the source of high margins. Today, the 40 largest companies in the S&P 500 make up approximately one-half of the market valuation of the index. Given their size, these businesses have a major influence on all measures of market fundamentals. Their median current margin (net income as a percent of sales) stands at 14%, which is roughly in line with their long term average margins of 12%. While margins are certainly high overall, we believe margins will gradually revert towards the long-term tendencies – and not crash – due to the makeup of the largest companies.

In our approach to valuation, we take a discounted cash flow view; meaning that current businesses can be valued based on the amount, growth, and risk of future earnings. Our analysis of the stock market indicates that its price is pretty close to our calculation of its value. Some of this can be attributed to lower interest rates, which serve to discount future earnings.

Consequently, if rates increase significantly, our assessment of market valuation may come under pressure.

General Economic Growth

If general economic growth stumbles, stock prices typically recede. We remain optimistic based on longer term trends in housing, energy, and consumer confidence. Recent readings of related indicators are mixed. However, the long-term trends are positive for sound reasons. Namely,

- housing buyers continue to be re-entering the market because of rising home prices (helps those “underwater”) and incentives (low average prices and rates)
- domestic energy production is large and on the rise, which stimulates domestic investment, imports and exports, and
- consumer confidence has been lower than its long-term average, but trending up towards normal levels

Market Psychology

Finally, spooked investors remain the third big threat to stock prices. As Quantitative Easing comes to an end, volatility will pick up in our view. Predicting the thoughts of others before they occur is far from science, though. Most investors already seem to be quite nervous about stocks for a variety of reasons, including the end of Quantitative Easing. Consequently, the fear of its end may already be “priced into the market” to some extent.

We believe a moderate level of cash is prudent today – at least within an equity portfolio. As 2013 has been a strong year, volatility will pick up and opportunities will present themselves as prudent uses of cash.

In Summary

Much of our present thinking stems from the Federal Reserve’s use (and prospective end) of Quantitative Easing. Our view is that investors should maintain their personalized long-term strategic allocations, while minimizing certain risks on a tactical basis. Specifically:

- interest rate risks exist while other sources of yield make a lot of sense
- equities are positioned well from a long-term perspective, but opportunistic uses of cash will come into play as volatility picks up

As Captain Ahab says, “Look sharp, all of ye! There are whales here-abouts!”

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[i] *Mapping Global Capital Markets 2011*, McKinsey & Co., August 2011.

[ii] *Financial Globalization: Reset or Retreat?,* McKinsey & Co., March 2013.