2Q 2016 Market Insights
Can the Fed Get Its Mojo Back?
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Integrated|Capital|Management

Where have you gone, Joe DiMaggio? …… Joltin' Joe has left and gone away.
- Simon & Garfunkel

It is said that Joe DiMaggio was once asked why he gives 110% on every play, to which he responded…."Because there might have been somebody in the stands today who'd never seen my play before, and might never see me again." Impressions, credibility, and precedent are important. At the moment, the Fed has very little credibility. They have completely lost their mojo. Instead of markets looking for direction from the Fed, the Fed now appears to be a slave of markets. But how did we get here? I've often said, when referring to the formation of bubbles in asset classes, that bubbles form by taking one seemingly logical step at a time to a completely unreasonable destination. I think this thought applies here as well. It wasn't a seismic change, but rather a series of small changes in temperament, personality, thought process, influence, and of course policy tools that brought us to where we are today. So it isn't a question if the Fed has lost its mojo. They have in many ways. Rather, the question is to what extent, and can the Fed get it back? We discuss this and more in our 2q 2016 Market Insights; *Can the Fed Get Its Mojo Back?*

The Good Ol' Days – The Greenspan Era

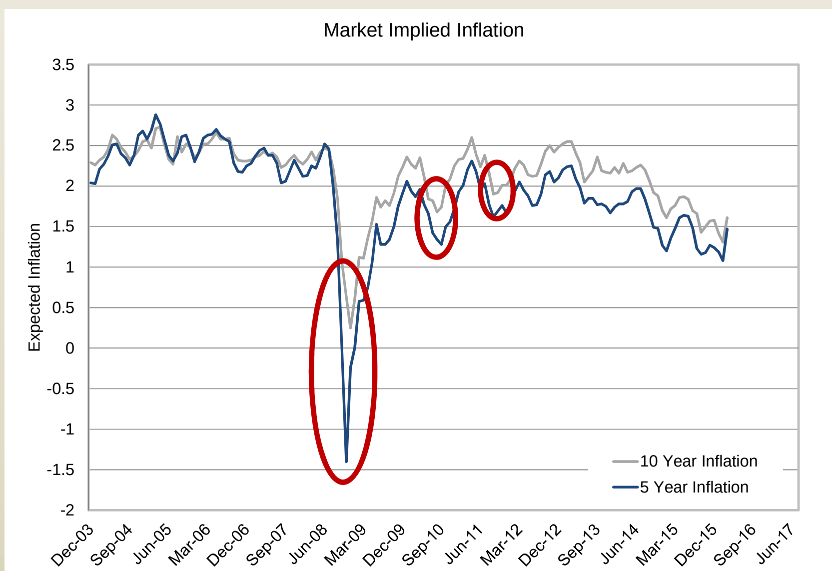
On June 2, 1987, President Ronald Reagan confirmed Alan Greenspan as successor to Paul Volker as Fed Chairman. From 1987 through early 2006, Greenspan oversaw an era of prosperity. He successfully navigated through the 1987 stock market crash, where the Dow Jones Industrial Average fell 22.5% on what has come to be known as Black Monday. He managed through the early 1990's recession and the bond market crash of 1994, where $600B of bond market value was erased in the first 9 months of the year. Later in the decade, he was faced with Long Term Capital Management, the Emerging Markets Debt Crisis, as well as the internet bubble and the recession that followed. While Chairman Greenspan's policy decisions were certainly noteworthy, some, including this author, would argue that the techniques he used had an unfortunate and unintended side effect. They actually encouraged risk taking. This has later come to be known, in a tongue-in-cheek manner, as the "Greenspan Put". The reference is, of course, to Mr. Greenspan's tendency of rushing to save markets as they fell. In essence, this created an asymmetrical return pattern. Speculate all you want, because if things went badly, the Fed would be there to save the day. This was the message received by many on Wall Street, and in turn, became the road map for each of his successors.

Ben Bernanke – Solution & Problem Rolled into One

It seems that fate is not without a sense of irony. In early 2006, Ben Bernanke was confirmed as Fed Chairman, replacing Alan Greenspan. The irony in the Bernanke appointment being that he was one of the world's preeminent experts on the Great Depression and the ideal candidate to manage the financial crisis that would come just 2 ½ years after his appointment.

Bernanke believed that central banks were at fault for both the Great Depression in the US, as well as Japan. In fact, he felt that in both cases, central bankers did not act with enough vigor, nor did they maintain a level of low interest rates long enough, to prevent depression and deflation. As history would soon prove, Mr. Bernanke would not fall victim to the same fate, slashing rates to zero and embarking on a historic balance sheet expansion known as quantitative easing. Along the way, he earned the nickname “Helicopter Ben”, a reference to his comments regarding a helicopter drop of money as stimulus. Early in the process, when questioned on whether or not the Fed was out of ammunition with rates at zero, Mr. Bernanke responded that through bond purchases, the Fed hoped to stimulate the economy by reducing the cost of capital or via a wealth effect through the portfolio rebalance channel[1]. In essence, he was saying that by reducing rates on safe assets, investors would either harvest gains on treasuries and spend them or reinvest them into riskier assets. In turn, this would result in investors bidding up the price of risk assets and reducing the cost of capital to issuing organizations. The so-called wealth effect was essentially inflating a bubble as a means to an economic end, a healthy economy.

Few realize, this was a hefty price to pay, as markets quite literally became addicted to Fed stimulus. Was it justified? Early on, I would say yes. Later, however, the cost became too great. In my opinion, Mr Bernanke knew the power of both a positive and, for that matter, a negative wealth effect. The positive wealth effect shepherded the US economy away from deflation. Unfortunately, the opposite side of that same coin, a negative wealth effect through deflating prices, could steer us back toward deflation. The genie was out of the bottle. The Fed was no longer the master of markets, but instead, had become a slave to them. The Fed was now pot-committed to this course of action; support markets or face deflation.



Market implied inflation reflects market consensus expectations for inflation over each horizon. The circled areas represent points where inflation expectations were declining, and the potential for deflation was rising. These moments were met with quantitative easing.

Data Source: FRB, iCM Capital Markets Research

Notice the circled areas in the chart on this page. They are clear instances where inflation expectations had declined, and where deflation could be argued. Each of these instances of decreased inflation expectations coincided with a round of quantitative easing. The first occurrence, during the 2008 financial crisis, was an extreme drop in inflationary expectations. The next occurred in 2010 and again during Operation Twist in 2011. While the decline in the expected inflation rate

[1] The portfolio balance channel is the aggregate mix of assets that investors hold as a collective group. By altering the mix of “safe” assets to “risk” assets the Fed could theoretically stimulate the economy by gains being harvested and spent or by reducing the cost of capital as risk asset prices increased.

was less than 2008, an argument can still be made that the decline was significant enough to warrant additional stimulus.

QE III is where it gets a little murky. From the inception of Operation Twist to the inception of QE III, inflation expectations were rising. So why QE III? The reason given was that unemployment had stopped improving. While certainly a serious issue, there are many, including this author, who would argue that extraordinary measures such as Quantitative Easing, altering the composition of the balance sheet, or dare I suggest negative interest rates, should be reserved for only the most dire of circumstances.

In total, under Chairman Bernanke's watch, the Fed allocated more than $3 trillion in stimulus. Mr. Bernanke was either caught running the same play once too often or succumbed to outside pressure. In either case, he furthered the belief that Mr Greenspan started. That is, Mr. Greenspan led markets to believe he would save them if they fell. Mr. Bernanke now fed the monster even more from the punch bowl. They needed him to advance. I am not here to argue that the Fed should throw caution to the wind and hike rates now, despite the markets, because the data simply doesn't support it. However, what I am arguing is that they missed their window. For the sake of moving the employment dial, QE III cost investors 52.91%(see the chart below) in non-fundamentally driven, gains on the S&P 500, an exceptionally steep price. The price, of course, being the formation of a bubble. The even greater cost was that they missed their window. That is, the period in 2012-2013 where inflationary expectations were on the rise. This was their opportunity to say things are good, let's move the policy dial upward from zero…and they missed it.

	QEI 11/25/08 - 03/15/10	Post QE I - Pre QEII Hint 03/16/10 - 08/09/10	QEII Hint - Conclusion 08/10/10 - 06/22/11	Post QEII - Operation Twist 06/23/11 - 09/20/11	Operation Twist 09/21/11 - 06/29/12	QEIII Hinted - Conclusion 07/02/12 - 10/29/14	Post QE III 10/30/14 - Present
Barclays Treasury TR USD	2.79	5.3	2.07	5.24	2.79	1.74	3.78
BC Aggregate Bond	13.69	4.62	3.12	3.34	3.42	4.88	3.17
BC High Yield Corporate Bond	79.41	5.12	10.4	-2.59	10.67	21.39	-3.72
S&P 500 High Quality	43.63	2.35	19.84	-6.18	15.75	54.53	12.36
S&P 500 Index	**39.44**	**-1.27**	**16.17**	**-6.12**	**15.28**	**52.91**	**5.01**
MSCI EAFE	44.51	-0.45	12.25	-14.67	3.2	13.95	-5.45
Russell 2000	57.61	-1.74	22.57	-13.45	17.11	48.13	-3.58
MSCI EM (Emerging Markets)	108.06	4.65	11.94	-14.05	0.5	13.75	-17.67
FTSE NAREIT All Equity REITs	66.06	10.6	18.47	-6.98	21.76	30.23	9.84
S&P 500 Low Quality	95.24	-1.49	21.49	-12.73	13.03	74.15	-3.21

Stimulus Driven Environment(% Return)	185.54
Non-Stimulus Driven Environments(% Return)	-2.67
Total Return(% Return)	177.92

As we had written previously in our 1q 2013 Market Insights Neither an Arbiter nor Speculator Be, markets have become dependent on central banks for their return. As central bankers attempt to engineer a soft landing, it has resulted in this very dangerous back and forth of tough talk, temper tantrums and kind words.

Data Source: Barclay's Global Investors, Standard & Poors, MSCI, FTSE Russell, iCM Capital Markets Research, data through 3.14.16

The Yellen Fed

On January 6, 2014, Janet Yellen succeeded Ben Bernanke as Chair of the Federal Reserve. During her confirmation hearing, Ms. Yellen repeatedly told senators she currently saw no major bubbles forming, including the stock markets. According to the Chair-woman, "Stock prices have risen pretty robustly, but I think that if you look at traditional valuation measures ... you would not see stock prices in territory that suggests bubble-like conditions." However in reality, as of January 31, 2014, equities were 25% over fair value on our price to adjusted-earnings based valuation metric. To put this into perspective, in late 2007, valuations peaked at 42% above fair value. On a traditional Shiller CAPE basis, these numbers would be 32% overvalued in January 2014, reaching peak levels prior to 2008 of 39%. Asked by Republican Senator Bob Corker if she would have the courage to "prick" bubbles, Yellen responded: "I believe that I would." From the beginning it seemed clear that Ms. Yellen would continue the Greenspan/Bernanke practice of asymmetrical risk.[2]

The Unintended Consequence of Good Intentions

Now that we've gone through the list of central bankers, there is one additional matter worth addressing. That is, the issue of forward guidance and inflation targeting. For those unfamiliar with this concept, allow me to explain. For many years the Fed would not specifically telegraph its next move, nor would they clearly state a desired inflation target. Beginning in 2012, Mr. Bernanke made the statement that the Fed would not raise rates until unemployment fell below 6.5%, so long as inflation remained below 2.5%. This came to be known as forward guidance. It is essentially clarity…stating your intentions clearly and living up to them. In most instances, strike that all instances, being forthright and dependable are admirable characteristics that are disappointingly absent from most things these days. While I was an initial supporter of this clarity, it sadly doesn't work in this case. I'm not advocating dishonesty or anything of the sort, but rather a bit of ambiguity. You see, markets hate uncertainty but, it is uncertainty that creates balance. Hyman Minsky, the famed economist, wrote that stability is ultimately destabilizing. In other words, when there is too much stability, folks begin to do some wild and crazy things like speculate. Forward guidance puts too many investors on the same side of a trade, which is also conducive to bubble formation. Markets function best when they act as a price discovery mechanism. They efficiently process the pros and cons of a situation, with risks balanced on each side. The price becomes the midpoint. Anything else is unbalanced and ultimately destabilizing, as Minsky suggested.

While the evidence the Fed has done a poor job of preventing or even creating asymmetric risk is pretty damning, allow me to offer one additional thought with regard to our current bankers, inclusive of Ms. Yellen. These are the brightest economic minds in the world…how is it possible that they don't recognize this? That is, Mr. Bernanke was astute enough, despite a misstep or two, to recognize the power of a wealth effect on the economy. Is it possible that Ms. Yellen is choosing her words very carefully so as to not tip this very top-heavy apple cart? Perhaps she is more aware of the existence of a bubble as it would appear. After all, how would markets react if she did acknowledge a bubble? Probably not well. So, let's consider the facts. In the past year, the S&P 500 has hardly moved, advancing at an annualized rate of 1.57%. Assuming she does recognize the bubble, is slowing the upward momentum not the first step to a "soft landing?"

[2] Asymmetric risk is a condition where the risk of loss is not as great as the reward. The problem with this condition is that it encourages speculation and is conducive to the formation of bubbles.

While part of me misses a good old-fashioned, brash, cigar smoking, curmudgeon as a central banker[3], I am at least hopeful that Ms. Yellen's tact is what is necessary at the moment, even if it seems like the capital markets are in command. The title of this article, '*Can the Fed Get Its Mojo Back?',* poses an interesting question. In my humble opinion, they would need to restore risk to markets to 'get their mojo back'. There should be a cost to those who speculate wildly. I suspect that this will require a little less clarity from our bankers, so as to restore balance to risk pricing. Let there be opposing opinions, a seller for every buyer. After all, that's how markets are supposed to function. Thank you for your trust and confidence.

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[3] Paul Volker is a former Fed Chairman known by many for his brash, cigar smoking ways. Despite heavy criticism at the time, he is credited with having the courage to breaking the back of inflation in the early 1980's by hiking interest rates to never seen before levels.