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Don't Fight the Fed

The Federal Reserve announced a new program of bond purchases last week, marking the start of QE3 (the third round of 'quantitative easing'). Furthermore, Germany's top constitutional court cleared the way for Germany to ratify the ESM (European Stability Mechanism), a permanent bailout program for market purchases of distressed eurozone sovereign bonds. The Fed had been telegraphing its intent to initiate QE3 for weeks and, correctly anticipating a new dose of monetary stimulus, risk assets have been rising through most of the summer – the S&P 500 is up 14% from last June's low. There is still plenty to worry about – the US fiscal cliff, the eurozone financial crisis and recession, a Chinese hard landing – but in the framework of our investment rules – *don't fight the Fed, don't fight the trend, and beware the crowd at extremes* – we do not want to be underweight risk assets given aggressive central bank stimulus, rising trends in US and now international equity indexes, and investor sentiment that has not yet reached an optimistic extreme. Thus, over the past six weeks, we have increased risk assets in RiverFront's portfolios, both in the US and abroad. Although we still have some cash to deploy in our more conservative portfolios, we have reduced cash in more aggressive portfolios by more than 50% over the past month, and they are now mostly neutrally positioned (i.e., in line with their benchmarks).

An announcement of a new round of QE was widely expected following last week's FOMC meeting. The Fed did not disappoint, indicating it will purchase $40 billion of agency mortgage backed securities per month and will continue its already existing 'operation twist' until its expiration at the end of this year. Most importantly, and a distinct difference from QE1 and QE2, the Fed presented QE3 as an open-ended program dependent on improvement in the jobs market, saying in the post-meeting statement, "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 (in unemployment) is achieved in a context of price stability." The Fed appears prepared to sustain QE3 for quite some time; the Fed's central tendency forecast for the unemployment rate is between 7.6% and 7.9% at the end of 2013 – not that far below 8.1% currently. So even after 15 months, the Fed still expects that the unemployment rate will be well above its longer range target of between 5.2% and 6.0%. Furthermore, ISI Group points out that the following statement from Bernanke's press conference was powerful and unprecedented: "If we do not see substantial improvement in the outlook for the labor market, we will continue asset purchases until we do."

We think QE3 will prolong US stocks' cyclical bull market, cause bonds to underperform stocks (as inflation expectations start to rise) and, by specifying purchases of mortgage-backed securities, will also help support the housing market, which has begun to show some signs of recovery this year. The S&P 500 rose 36% during QE1 and outperformed bonds during that 16-month period. Stocks also reacted well to the anticipation and start of the 8-month QE2, but peaked before its conclusion. Thus we view the open-ended nature of QE3, both in magnitude and duration, as a positive for stocks. Notably, both Fed

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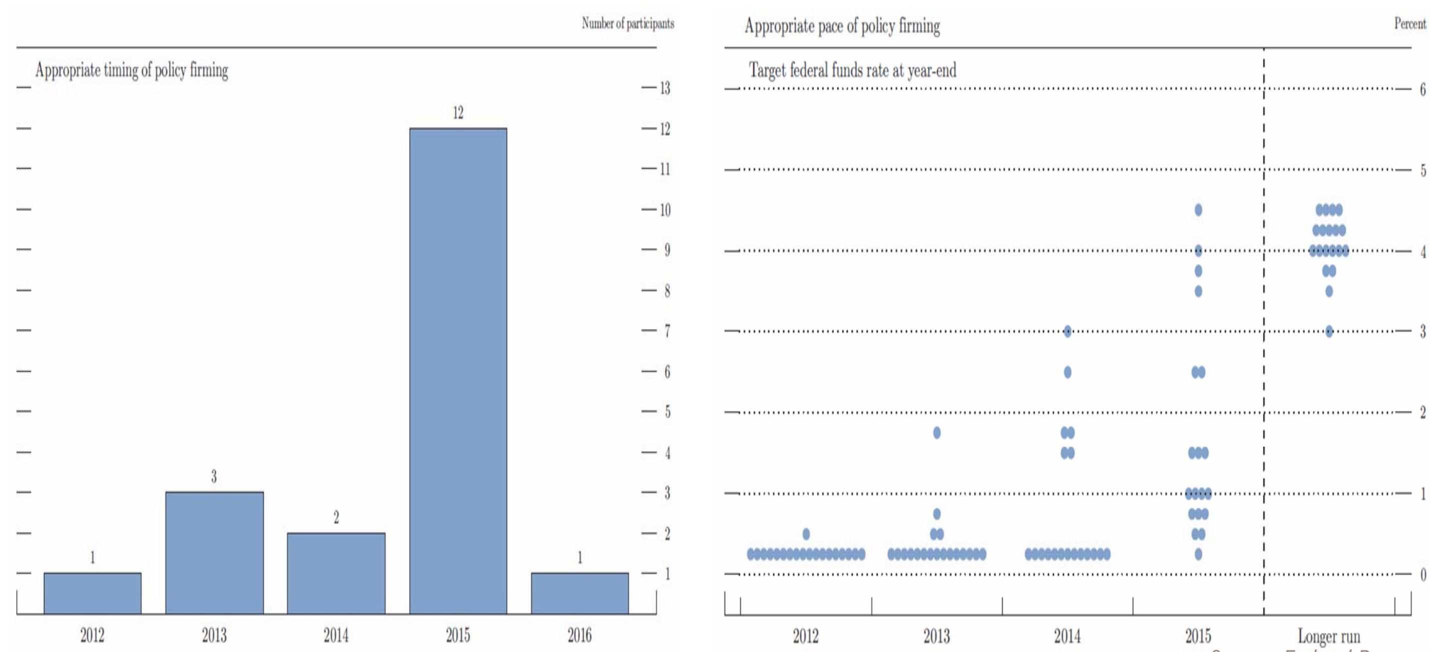
A key sentence from the Fed's post-meeting statement highlights the open-ended nature of QE3: "the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement (in unemployment) is achieved in a context of price stability."

Chairman Bernanke and ECB Chairman Draghi regard rising stock markets as one of the key channels through which QE supports the economy.

August CPI inflation, reported last week, was supportive of the Fed's QE3 program with respect to the Fed's attention to price stability. Year over year, headline CPI rose 1.7% and core CPI (excluding food and energy prices) rose 1.9%, the smallest increase since July 2011. The Fed's inflation objective is 2%. To be sure, inflation expectations have already started to rise and are up to 2.7% from 2.1% at the end of July, as measured by the spread between nominal 10-year Treasury yields and 10-year TIPS. However, we think the Fed will tolerate a rise in expectations this time since it is so focused on unemployment.

An important step to ease Europe's financial crisis was taken last Wednesday when Germany's Federal Constitutional Court dismissed motions to block ratification of the ESM by the German parliament. The court's ruling came with some conditions, which limit the ESM's liabilities on German taxpayers (currently set at €190 billion) and require the approval of the German parliament for any increase in liabilities. Thus, with the ESM set to come on line, Spain and Italy's short-term funding concerns have eased and the eurozone has bought more time to address structural issues. Longer term, we believe that Spain and Italy must move away from a focus on austerity and budget cutting and begin to embrace the labor market reforms that both Spanish Prime Minister Rajoy and Italian Prime Minister Monte have attempted but have had difficulty in getting implemented. A more aggressive ECB, stabilizing market trends, and continued extremely negative sentiment have caused us to change our stance regarding Europe. We no longer want to be underweight, and have restored our European exposure to a neutral weighting, as detailed in last week's Weekly View.

THE WEEKLY CHART: FED EXTENDS ITS OUTLOOK FOR TIGHTENING POLICY



Source: Federal Reserve

In addition to QE3, the Fed decided to extend its 0–0.25% interest rate policy to at least mid-2015. As the chart on the left shows, 12 (out of 19) FOMC participants now believe 2015 will be the appropriate time for policy firming. In June 2012, the numbers of FOMC participants who judged that the first increase in the target federal funds rate would occur in 2012, 2013, 2014, and 2015 were, respectively, 3, 3, 7, and 6. In the right chart, each shaded circle indicates the value (rounded to the nearest 0.25%) of an individual participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run. Most FOMC participants believe the long run target for fed funds is around 4%.

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