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QEternity or QEulogy?

The nameplate on the Chairman's door at the Federal Reserve changes very infrequently. There have only been three since 1979 and fourteen in the history of the institution. Come the end of January 2014, though, there will be a new boss on Constitution Avenue. President Obama has nominated Janet Yellen, current Vice Chair and former head of the San Francisco Fed, to take over for Ben Bernanke.

If the economy was humming this change of control would not be a big event. But humming we are not. Short-term interest rates, the conventional Fed domain, have been effectively zero, yet that alone was deemed ineffective medicine for the moribund US economy. Rather, the recovery has been supported by unconventional Fed policy, specifically quantitative easing (QE), for over five years now. The efficacy of the Fed's QE program is rightly debated, but it is hard to argue that they have not succeeded in driving down mortgage rates (thus boosting housing) or that they have not animated a visible hand in the red-hot stock market.

But will the QE support endure the change in power? Per their most recent meeting minutes, highlighted below, the Fed will continue to buy $85 billion in mortgage and government bonds. (This is the part dubbed QE; the second bullet is the more traditional policy that the first thirteen Fed Chairs would have recognized, maybe minus the precise unemployment and inflation targets). All signs point to a continuation of this stimulative stance at a Yellen Fed.

Current Fed Policy

- Purchases of $40 billion per month of agency mortgage-backed securities and $45 billion of longer-term Treasury securities until "the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective" is met.
- Federal funds rate at 0 – 0.25% so long as unemployment rate remains above 6.5% and inflation projections do not exceed 2.5%.

Source: Minutes of the Federal Open Market Committee October 29–30, 2013

Chairwoman Yellen may indeed carry Bernanke's QE torch, but most think that the stimulus will be reduced (tapered) in the coming months. We believe that Fed tapering is one of the top three risks facing investors today. On the other hand, the possibility that QE lives on is also a very real upside risk that we are weighing. We judge the former (QEulogy) more likely than the latter (QEternity), but thought it most important to outline our views on how asset prices could be affected under each scenario.

Expected Impact on Fixed Income Securities

We will begin with probably the most straightforward relationship between QE and asset prices: fixed income securities. The thrust of the Fed's policy is to drive the real, or inflation-adjusted, rate of return on bonds artificially low. Economic theory says that there is a supply curve of capital dictated by savers and a demand curve comprised of those looking to invest the capital. Savers are incentivized to forgo more (less) consumption as the equilibrium real rate of interest increases (decreases). Those looking to invest the capital have the inverse reaction to changes in the real rate.

Figure 1: The REAL Treasury Yield
10 Yr Constant Maturity TIPS Yield (%)
Source: Bloomberg

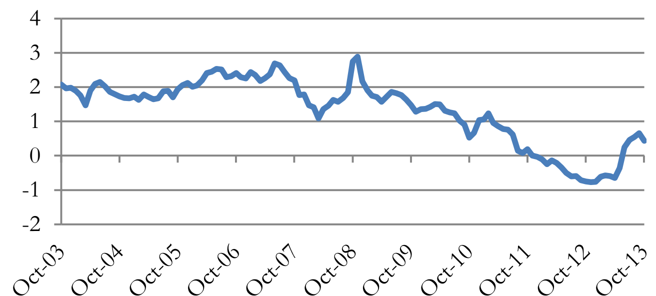


Figure 1 above shows how successful the Fed has been at driving real rates into (really below) the ground. Homebuyers have responded by purchasing more houses and builders have increased new construction. Corporations have used the opportunity to refinance their debt at historic lows thus bolstering their balance sheets. Already near zero, however, it is hard to see how the Fed can push real rates any lower.

If QEternity is the Yellen paradigm, and rates are stable, we would expect very low single digit nominal returns from the parts of the bond market that are most sensitive to interest rates (government bonds, TIPS or treasury inflation protected securities, high quality municipals, agency mortgages). The higher yielding sectors of the market that we prefer should earn 3 or 4% more.

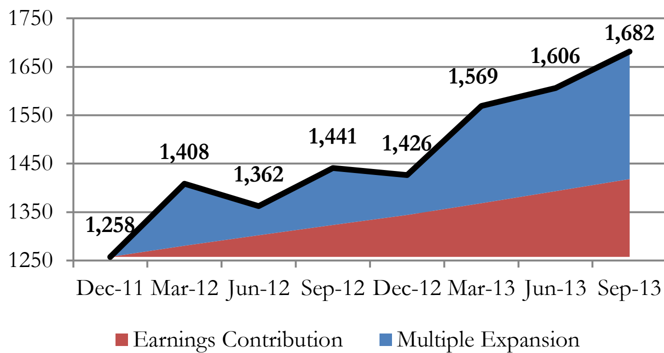
However, if QE is phased out clumsily, fixed income markets will likely sell-off. Higher interest rates will ultimately represent a shift in

favor of savers, but the period of adjustment could mean a loss of 5%+ for each 1% abrupt increase in the 10 year treasury yield. We think our preferred credit sectors will fare better, primarily thanks to the higher coupons on offer, but do expect volatility. Our allocation to catastrophe bonds, though, should be more immune to monetary policy; if anything, these bonds should benefit from higher rates as they carry floating rather than fixed coupons.

Expected Impact on Equities

The stock market, at least in recent periods, has become addicted to QE. Consider Figure 2. Much of the strength in equity markets in 2012 and 2013 has been on the back of P/E multiple expansion. In other words, the underlying corporate profit environment has shown improvement, but stock pickers have been willing to pay more and more for those profits.

Figure 2: Make-up of an S&P Expansion
Cumulative Contribution of Earnings and Multiple Expansion to S&P Price Level
Source: Standard & Poor's



QEternity does not offer an obvious reason for this trend to reverse. There are likely more buyers tired of earning zero in a money market have yet to buy into the trend. Any boost to corporate earnings from refinancing debt is probably gone, but we would expect, in a QEternity scenario, the market to continue rising as those earnings continue to be bid up. Each one point expansion of the P/E multiple is worth about 7% in S&P returns; it would not be surprising to see two or three extra multiple points if Yellen hints at a longer period of QE. The tapering scenario should be a positive for stocks because it will be a signal that the economy has a clean(er) bill of health. On the contrary, we believe it will be a negative event. The incentives to own stocks as opposed to bonds will erode. The risk averse investing community that has reached for yield in equity or hybrid equity securities will see a more palatable opportunity in bonds emerge. If the market reacted by giving back all of the P/E multiple expansion of 2012 - 13, we would be back to 1420 on the S&P, a 20% drop.

Expected Impact on Alternatives

The changing of the guard at the Fed will impact alternatives in different ways. The relationship with directional equity strategies is straightforward; gains or losses should be proportional to the fund's net exposure. AQR, a money manager, reports that the average fund in this space has a 0.5 beta, or sensitivity, to the MSCI World Index right now. A 20% QEternity jump should result in a 10% gain whereas a 20% QEulogy plunge should cost 10%.

Many of our hedge funds are taking advantage of inefficiencies in the credit sector – these managers' results will be more closely correlated with results we discussed in the fixed income credit section. There are a few positives we see with these strategies no matter the QE paradigm: meaningful exposure to floating rate bonds that are insensitive to rates, strong corporate balance sheets, and an event driven thesis to unlock value that should stay intact barring market panic.

Arbitrage strategies' downside should be limited due to their low beta to the stock market. However, rising interest rates would likely shrink the deal universe available for merger arbitrageurs as private equity sponsors struggle to make the math work for buyouts. Macro funds should exhibit very low correlation to the scenarios described above and potentially add positive returns in a downmarket. Managed futures strategies are at risk of being whipsawed as price signals likely have pushed them long the equity market, but our plan is not to find out – we are moving to be out of the space by year end.

Lastly, we should comment on master limited partnerships (MLPs) and real estate investment trusts (REITs). Both have benefitted from the reach for yield and are thus vulnerable to renewed competition from bonds should they start to pay better coupons. We think the impact from either QE scenario on these assets will be commensurate with equities.

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