Market Commentary - March 2017 View this email in your browser

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# Quantitative Easing is Winding Down. What Was Its Impact?

The Federal Reserve engineered a program called Quantitative Easing (QE) after the 2008 housing market collapse to help the U.S. pull out of the Great Recession. QE was a key part of a series of monetary policy strategies the Fed employed including lowering interest rates (effectively to zero), rapidly increasing the money supply, and purchasing fixed income securities (and mortgages) in the open market. QE ultimately increased the Fed's balance sheet five-fold. The debate continues whether QE actually worked and what the future consequences might be. What is clear, however, is how certain groups were impacted: savers, investors, U.S. companies, and the Federal government.


## Savers

- Lower interest rates reduced interest income which hurt savers. This hit retirees especially hard as many have spending budgets based largely on their investment income.

- Those savers (again, especially retirees) who couldn't live on diminished fixed incomes were then forced to take risks they otherwise would not have. In many cases, the investments of choice were dividend stocks and lower quality bonds. How will these mostly risk averse individuals react when the next bear market arrives or interest rates move up sharply (which will depress bond prices and interest sensitive stocks)?

## Investors

- Investors were the biggest beneficiary of QE which was looked upon as a safety net (or put option) on the value of securities, especially stocks. Disjointed price signals resulted in higher valuations as the bull market aged. As a result many stocks today are priced to perfection as the bull market turns 8 years old this month.
- Low interest rates encouraged companies to borrow and buy back their own stock and increase dividends at a more rapid rate. This also helped push stock prices higher.

## Companies

- As previously mentioned, companies borrowed money to support their stock prices. This siphoned money that would have otherwise been invested in capital expenditures (capex) designed to build long-term enterprise value. Although in all fairness many companies have not had sufficient confidence in future growth prospects to invest in capex.
- The profits of healthy companies in the financial sector who rely on higher rates and an upward sloping yield curve were eroded (mainly banks).

## Government

- The Federal Reserve's "wisdom" overpowered the wisdom of market borrowers and lenders who were not clearing at the market rate but rather at the "Fed rate."
- QE took the pressure off government to act on fiscal initiatives as the Fed took and still retains much of the spotlight.

One of the key takeaways now that QE is ending is that it was an absolute boon to investors. We remain in one of the longest and strongest equity bull markets in history. Main street, however, didn't fare as well. Economic growth has been half the normal rate while corporate profits (which encourage companies to hire) have only risen on average 3% a year since 2011. Importantly, the ultimate impact of the QE/ monetary policy unwind is not well understood yet Fed "rate normalization" is bound to have additional consequences for investors, companies and government.

# While the Trump Rally Has Been Impressive, Bonds Suggest It Won't Last

Ten-year Treasury bonds have rallied 25 basis points from a mid-December high of 2.6% to February's close of 2.35%. Falling rates argue that the Trump reflation stock rally–a bet on faster growth with resurgent inflation–will not last. With risk assets (stocks, REITs, MLPs and high yield bonds) by some measures as rich as they have been since 2000 there is reason for concern. Further, market professionals currently anticipate the Fed will raise rates three times (or around three quarters of a point) this year, which would be expected to diminish liquidity and pressure risk assets–at least under normal circumstances.

Only time will tell but we believe the bond market has it right this time. Debt levels remain high and economic growth is more likely to disappoint (remaining near 2% - 2.5% not the 4% now hoped for). Stocks are pricing in a robust 23% increase in earnings over 2017 and 2018. Without this profit surge coming to fruition, stocks are unlikely to advance much more for the remainder of the year.

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