investors first

ALL IN!

By Robert L. Rodriguez
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The Fed initiated QE3 today by announcing its plan to buy $40 billion per month of agency mortgage-backed securities, finishing Operation Twist by year end and keeping the federal funds rate at 0 to ¼ percent through at least mid-2015. Additionally, "If the outlook for the labor market does not improve substantially, 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 is achieved in a context of price stability." With this statement, the Fed has gone "ALL IN!"

The Dow Jones Industrial Average responded by renewing the "Risk On" trade with a 206 point rally. The Fed's actions have raised the ante for investment professionals and other organizations where their portfolios are under invested or "under risked". With little time remaining in this investment year, the pressure on money managers to do something has become more intense. Needless to say, these monetary intrusions are just more of the same and the Fed Chairman is trying to bludgeon the market into taking risk. The key question is, "Will it work?" In the short-run, the Fed can win. In the long-run, will there be costs or disruptions for the economy and investors from these actions?

Since the Fed initiated its traditional and non-traditional monetary policies in reaction to the Great Recession, with the goal of stabilizing and stimulating an economic recovery, economic performance has been poor and not what was anticipated. The Fed's forecasts have been overly optimistic. During the past five years, there have been 53 downward revisions to its economic growth forecast versus 22 upgrades.[1] The forecast released today continues, in my opinion, this overly optimistic predilection with its growth estimates for 2013 and 2014 increasing while a decline in the unemployment rate by 0.1-0.3% is anticipated, when compared to its June forecast. Unlike the Fed, since Q3 2008, I viewed a real GDP recovery growth rate of barely 2% as the most likely outcome and we would not have a "V" shaped recovery, as was typically expected. My "guesstimate" has proven to be fairly close to the actual outcome. In contrast, the Fed's high end central tendency forecast has been upwards of more than double my estimate, particularly for 2011 and 2012.[2] Why anyone would place credibility in the Fed's forecast is beyond me. Obviously, the revised outlook reflects a belief that its shock treatment will work. We'll see.

Since 2009 I have used the word "substandard" as the best way to describe how the recovery would unfold. I believed the economy faced structural headwinds that could last upwards of a decade or more. In a preliminary draft paper, *"Debt Overhangs: Past and Present,"* the authors concluded that since the early 1800's, the average duration before recovery took place from a debt overhang has been about 23 years.[3] The Fed Chairman recently expressed the opinion that he does not view unemployment as structural.[4] However, he is using this "All In" approach to shock the economic system. This reflects something other than normal times. He believes if the Fed gets interest rates low enough for a sufficiently long period, the recovery will finally gain traction. This is pure speculation. I view this approach as highly dangerous, misdirected and untested.

The economy's failure to respond sufficiently to traditional monetary and fiscal stimuli, as would be expected from a Keynesian viewpoint, raises many questions as to the soundness and applicability of this approach to current circumstances. Unlike previous post WW2 recessions that were more a function of inventory cycles, this contraction had its genesis in excessive credit growth that led to malinvestment in housing and other long-term consumer and commercial assets. Unsound monetary and fiscal policies helped create this speculative environment. In a similar vein, between 1924 and 1927, an easy monetary policy of low interest rates, with the goal of stabilizing the wholesale price level while stimulating economic growth, led to excessive capital investments in industrial goods industries and eventually, to investment speculation. At the time, several Austrian school economists were quite negative of this policy and believed the after effects from these actions would be long lasting. In a similar fashion, I expressed the view the Fed was contributing to financial excess between 2003 and 2007 with its misguided monetary and regulatory policies. Chairman Bernanke is held in high esteem by the consensus. As usual, I am not with this consensus. He refuses to admit the Fed made monetary policy errors that helped create the housing bubble. He maintains it was a worldwide savings glut that caused it and not the Fed. In fact, for both 2005 and 2006 he held the view that there was no housing bubble—a major miss. In contrast, at FPA we were of the opposite opinion and took action in the portfolios to hopefully protect capital before the bubble burst. The only retraction Bernanke has made was in reference to his May 2007 comment that he thought the subprime mortgage mess would be contained. I publically expressed the opposite view and said that subprime was the canary in the credit coal mine.

It is my view that investment managers do not appear particularly concerned with, nor worried about, the finer nuances of an academic debate between two different schools of economic thought. It is all about not underperforming the market or a benchmark, so don't fight the Fed. Unfortunately, a strategy of following the Fed's urging to take on greater risk will likely end in heartbreak. Should the stock market continue its upward march, both our clients and FPA's portfolio managers will be tested. This is a time for discipline. Given that economic growth is languid at best and is likely slowing, the divergence between the stock market and economic reality cannot be sustained. One or the other has to adjust.

The Fed's actions today are but another attempt to reshape the yield curve. Some would say manipulate. The end goal is to improve housing demand via lower interest rates and spur capital spending and risk taking. The shape of the yield curve will be an important indicator of things to come. If the Fed is successful in bending the curve downwards with lower long-term rates, this will place extraordinary pressures on fixed income investors and financial organizations. It will enhance the "risk trade" and I believe it will result in creating financial cancers because capital is or will likely be deployed in an unbalanced risk fashion, resulting in a duration or credit risk mismatch. Call it a bubble of another sort that will result in unintended consequences. Should the yield curve steepen, with ten-year bond yields moving above 2%

while short-term rates are anchored near zero, it would imply that a longer term inflation fear is re-entering the market. Inflation fears are not just driven by improved economic expectations. The Fed believes it can manage this risk. It also believes it can manage the unwinding of its massive QE portfolio without market disruption. This is opinion and not fact based. Intelligent people can disagree about this view.

Future outcomes will also be materially affected by whether Chairman Bernanke remains in office next year, the composition of the new congress and who will be president. I believe that Chairman Bernanke should be replaced with a new far less monetary policy intrusive chairman. The composition of the congress and who the next president is will likely shape how or if a fiscal Grand Bargain can be achieved. Chairman Bernanke has consistently argued that any expenditure cuts should do no harm to the nascent recovery. As is typical in Washington, postpone the tough decisions.

2013 is a critical moment in time. If a material and timely fiscal restructuring does not take place by next September, I fear and believe that it will not occur before 2017. Unfortunately, if this were to occur, my 2009 warning of a crisis of equal or greater magnitude than the Great Recession by 2017 would be a more likely outcome. Dave Walker, CEO of the Comeback America Initiative, www.tcaii.org, who I have referenced several times before, also believes 2013 is a critical year. In light of that, he began the **$10 Million A Minute Tour** that will cover a dozen states by bus. It is a fact-based, non-ideological tour that focuses on the tough choices we face and sensible, non-partisan solutions that can achieve bipartisan support and restore fiscal sanity. I am both a moral and financial supporter of this tour.

My worst fear is that fiscal gridlock continues, coupled with the policies of this activist Fed Chairman. Today's Fed actions add to my anxieties. "ALL IN" may be a good strategy for poker but not for this economy.

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[1] *"Over-Optimistic Fed May Backtrack Again on Forecasts,"* Jonathan Spicer and Ann Saphir, Reuters, September 11, 2012.

[2] Minutes of the Federal Open Market Committee, November 3-4, 2009.

[3] *"Debt Overhangs: Past and Present,"* Carmen M. Reinhart, Vincent R. Reinhart and Kenneth S. Rogoff, April 15, 2012.

[4] *"Monetary Policy since the Onset of the Crisis,"* Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, WY, August 31, 2012.