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DE Investment Strategy

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"Open-Ended" QE with Implications for the Stock Market and Asset Allocations

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The recent shift in Federal Reserve monetary policy, which should be dubbed QE-"Open-Ended" or QE-"Unlimited" rather than QE3, represented a momentous change in the theory, approach, and application of United States monetary policy. For this business cycle episode, the Federal Reserve has crossed a line into new territory, designed to accelerate economic growth, end the continuing sluggish and subpar pace of U.S. economic activity and to bring about a lower unemployment rate, faster, within the context of sustained and sustainable price stability.

What makes "Open-Ended" QE different from QE1 and QE2?

Different is the promise of repeated applications of monetary ease via the Federal Reserve's balance sheet rather than the federal funds rate and its continuation until the economy and labor market perform a lot better, and faster, in achieving "full employment" within the context of "price stability." Implied is that inevitably when inflation rises, a shift in emphasis toward the objective of price stability would occur.

Repeated easings contingent on the economy, labor market and/or inflation is different from the one-time changes in policy that defined QE1 and QE2. *QE1 was fixed in amount and timeline as was QE2.*

Increases in the size and changes in the composition of the Federal Reserve's balance sheet as opposed to fixed one-time shifts should "permanently" affect "financial conditions," i.e., intermediate- to longer-term interest rates, the stock market, and the U.S. dollar, so as to stimulate the economy, then with lags bring about a lower unemployment rate. Subsequent Federal Reserve actions will be contingent on progress in raising economic growth and lowering the unemployment rate to more rapidly approach full employment. Higher inflation eventually can be expected.

In the theory and application of macroeconomic policy, switching from one-time, essentially temporary, policy actions such as QE1 and QE2 to open-ended easing and repeated increases in the size of the balance sheet *until* sufficient progress has been made on the economy represents a *huge* change. The Fed will keep easing with changes in balance sheet size and composition open-ended or unlimited. In theory, one-time shifts in exogenous policy instruments produce only one-time, or transitory, effects and in a dynamic system like the U.S. economy would be associated initially with increased economic growth that would fade over time.

This is to be contrasted with sustained growth and clicking-in of the business cycle mechanisms that can launch real economic growth to a higher rate if changes in a monetary or fiscal policy instrument are *permanent*.

An analogy might be a spaceship (the U.S. economy) that has been launched into orbit (QE1 and QE2), entrenched in orbit but low-flying. Exogenous to the spaceship are meteorites flying around in space that might strike it and knock it off course; in the economic case, the analogy is negative shocks from the European and Eurozone Crises and potentially the coming Fiscal Cliff (the meteorites). The Fed will apply bursts of propulsion to that low-flying spaceship until it reaches a higher orbit where it can remain. The Fed will keep applying bursts of propulsion until the spacecraft reaches a certain altitude, one that will be maintained (stronger real economic growth and a lower unemployment rate) by the processes that operate on it. *The repeated bursts of propulsion until a higher orbit is reached as opposed to a one-time burst represents the change.*

The balance sheet of the Federal Reserve, and very likely other central banks, now becomes the focal point for monetary policy as far as the eye can see, given all the advantages and nuances available to monetary policy in using the balance sheet.

Decision Economics, Inc. (DE) has upgraded its "Baseline" Prospect, as the recent Fed policy action and its implications make that outcome more likely. Other, more negative, Alternative Scenario odds collectively are lower, although still prominent.

DE also is altering its Broad Asset Allocations and making some tentative changes to its Sector, Industry, and Country allocations as a consequence of the shift to "Open-Ended" QE.

A higher allocation to Equities, a small reduction in the allocation to Fixed Income, and less-defensive Sector allocations are main changes. Investors should also look favorably at commodity-exporting countries when thinking about global country asset allocations because of positive effects from higher commodity prices.

Once again, allocations to housing-related Industries and Sectors are raised. QE2 "Open-Ended," especially with emphasis on increased purchases of MBSs, should be quite favorable to housing.

Indeed, some 20 months ago DE launched an “Entrenched Housing Recovery and Expansion” as one of its Top 10 macro top-down driven investment and investable themes.

A bottoming-out of housing and its recovery was forecasted by DE back in early 2011. *Forward indicators* of increased housing activity at that time included: 1) affordability; 2) refinancing and financing via extraordinarily low interest rates, although still tight bank credit; 3) an improving household sector balance sheet from a better stock market and lesser declines in housing prices; 4) a slow but diminishing supply of available housing through foreclosures and forgiveness; 5) improved household financial conditions because of a very large decline in debt; 6) and quantitative assessment through DE models for lags in home sales to housing demand, from housing starts to home sales, and then from real residential construction to U.S. real GDP.

The “Housing Recovery and Expansion” is now in relatively full bloom; it is in-train; it has happened and is adding to U.S. real economic growth. It has added to real U.S. economic growth this past year and will next year; indeed, housing activity is a pillar of support to the business cycle upturn now.

The contribution of residential construction to real GDP is much less than it used to be, however. The proportion of residential construction-to-real GDP is less than three percent. It used to be about six percent. Nevertheless, increases in home sales, housing starts, and residential construction are an essential part of the U.S. business cycle upturn and will be a solid contributor to growth in real GDP for the duration of this business cycle expansion.

The Fed—Focus on the Balance Sheet

The Federal Reserve’s newest round of asset purchases should be thought of as “QE Unlimited” or QE “Open-Ended” rather than “QE3.”

Until yearend, the central bank will be adding $40 billion in mortgage-backed securities (MBSs) to its balance sheet, will continue making $45 billion of long-term U.S. Treasury securities purchases funded by sales of three-year term and under Treasury notes (Operation Twist), and be reinvesting the proceeds of maturing mortgage-backed securities. Increases in the balance sheet will likely continue until significant and sufficient progress toward full employment has been made.

Previous easing measures had a cap on the amount of balance sheet expansion and an end date—for example, the $267 billion Operation Twist Program announced in June 2012 to last until yearend; or QE1 ($1.2 trillion of mortgage-backed securities, $200 billion of Agency debt, and $300 billion of U.S. Treasury securities between late 2008 and March 2010) and QE2 ($600 billion of purchases of U.S. Treasuries and reinvest most of the proceeds of maturing mortgage-backed securities, from November 2010 to June 2011).

In subsequent meetings, FOMC Members will decide on policy based on economic and other data, looking at the prospects for full employment in the context of price stability over a faster timeframe than previously.

At any Meeting, the FOMC may choose to change the size of the balance sheet, its composition, point of entry for security purchases on the yield curve, types of securities other than U.S. Treasuries that might be bought, varying maturities, and yield-flattening actions such as Operation Twist.

This focus on the balance sheet instead of the federal funds rate represents a major shift in monetary policy.

This has been occasioned by the zero lower bound on interest rates, to be kept that way as stimulus. The balance sheet focus permits an easing of monetary policy analogous to reducing short-term interest rates, with similar effects occurring in the system and eventually a better economy and lower unemployment rate. Decisions will take a different form, but will be analogous to how the federal funds rate was used. With the federal funds rate indicated at near zero until well into 2015, changes in policy clearly have to focus on the balance sheet. Numerous variations of monetary easing, or tightening, can be designed using the balance sheet as well as Communications Guidelines around them.

As *examples*—

- **Policy Hold—Neutral Bias:** Instead of holding the federal funds rate constant, under a balance sheet approach "Hold" could mean the Fed would continue the $40 billion of monthly purchases of MBSs. If Operation Twist ends at yearend, as planned, that would be part of a Policy Hold. If no leaning toward further Quantitative Easing were indicated in the FOMC Statement, one could say that the Policy Bias was Neutral.
- **Policy Easing—Easing Bias:** If the Fed were to step up monthly purchases of MBSs to over $40 billion, this would be comparable to a cut in the federal funds rate; that is, an easing. Hints that further moves in this direction could be made might then indicate Policy Easing with a Bias toward Ease.
- **Policy Tightening—Neutral Bias:** If the Federal Reserve were to decrease monthly purchases of MBSs to less than $40 billion or end the latest Quantitative Easing program entirely, this would be comparable to an interest rate increase under the old policy regime. If the Statement were to indicate concern over price stability and satisfaction with progress toward full employment and a lower unemployment rate, then the Policy Bias likely would be to Tighten.

The balance sheet focus is yet another attempt by the Federal Reserve to influence long-term interest rates, after interest rate reductions and forward guidance on the short-term interest rate path have proved, in the minds of many Members, insufficient to generate enough growth to lower unemployment fast enough.

The Fed will also look at the transmission mechanisms for asset prices impacted by balance sheet actions; for example, the U.S. dollar, equities prices, and various market interest rates—particularly mortgage interest rates. These asset prices, or for the Federal Reserve "financial conditions," can positively affect, although with lags, household and business balance sheets, spending, and then economic activity. Of course, that rationale was also presented in earlier QE moves, but the hope is that this "unlimited" or "open-ended" version of Quantitative Easing finally will have the intended effects.

The Federal Reserve is leading the Global Economy on this new way of quantitative easing. DE expects the Bank of Japan (BOJ), the Bank of England (BOE), and the European Central Bank (ECB) to undertake similar actions.

"Muddle-Through" Most Likely

The risk assessment for the DE Baseline and Alternative Risk Scenarios is altered by the Federal Reserve actions.

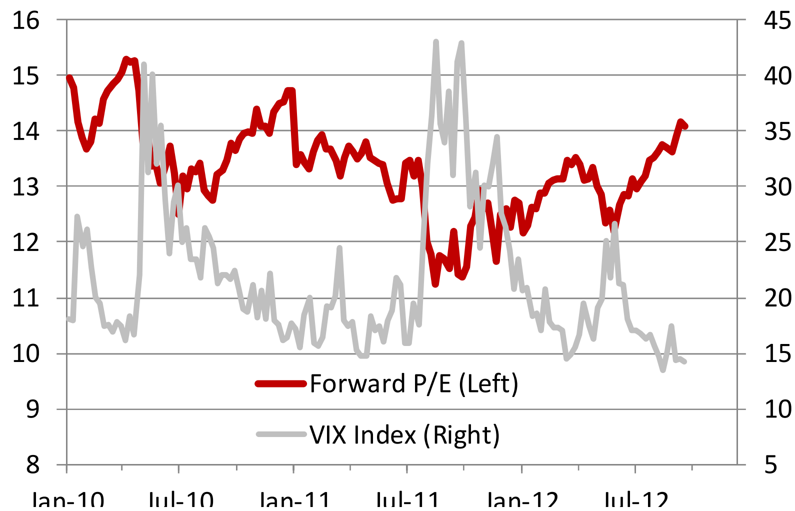
- *Baseline—"L" with uptilt at the bottom* growth path for real GDP has probability *increased* to 60% from 55%—real economic growth a little under 2% in 2012 and higher in 2013. *This is a shift! The Baseline Scenario is upgraded* on confidence that QE—"Unlimited" or "Open-Ended" will lift the U.S. economy up enough to avoid a Japan-like Scenario;
- *"Japan-Like"*—a stagnant growth *downgraded* to 5% from 10%. This scenario would have U.S. real economic growth sustained in a 1%-to-2% range;
- *U.S. Sovereign Debt Crisis—odds maintained* at 10% on a longer-term view that the U.S. deficit and sovereign debt problem has not been dealt with—the clock is ticking on this Scenario;
- *Delayed Takeoff—at 15%* (from as high as 20%). Lagged effects of easing monetary policy results in much stronger real economic growth in 2013-14 than in the Baseline;
- *Recession 2013-14—odds lower at 10%*. This result would be a consequence of the Eurozone Crises and the potential for a huge fiscal contraction if the full brunt of the U.S. "Fiscal Cliff" is permitted to strike.

DE Earnings Estimates Supported by "Open-Ended" QE; Forward Earnings Multiple on S&P500 Raised

P/E multiples are typically thought of in relation to interest rates, but short-term interest rates are pinned near zero. With increased use of the Fed's balance sheet and no easing of monetary policy by lowering interest rates in sight, investors need to incorporate balance sheet moves by the Fed into P/E calculations if these actions are believed capable of having an impact.

DE believes that the interest rate reduction equivalent to the implied expansion in the balance sheet could be about 15 to 25 basis points. Using the DE methodology that relates interest rates, business cycle correlates and other market measures to P/E ratios, DE has moved the S&P500 P/E valuation to 14 from the previous 13.

Chart 1
Earnings Command Higher Multiple
as Perceptions of Tail Risks Ebb
(Consensus Forward P/E, and CBOE Implied Vol. Index)



With S&P500 Operating Earnings estimated at $110 in 2013, fair value on the S&P500 would be approximately 1540 by end-2012. Since it is early in the fourth quarter, current fair value is roughly 1475 to 1500, up from the previous DE estimate of 1400-to-1425. Fundamentally, a worsening in the European downturn, and/or the Fiscal Cliff hitting or looking like it is going to hit, could produce a move down to 1400. Upside for the S&P500 is 1550 to 1575 which borders on the previous all-time high of 1565. But, it is doubtful that the equity market, given all the uncertainties and scenario risks that exist, could mount this level before the uncertainties ranging from the Fiscal Cliff to the European Crises to the earnings outlook, Election, policies to deal with deficits and debt, and the Fed have been resolved. *But, Corrections should be fewer, given the Federal Reserve shift in policy and ongoing support from the Federal Reserve if the economic situation in the U.S. should falter.*

If Europe can get through its Crises, the U.S. Election and the Fiscal Cliff pass with some resolution of the uncertainties, and repeated central bank easing continues, a 2014 S&P500 Operating Earnings estimate of $118 for 2014 is expected. On a 14 P/E ratio against forward earnings, *fair value of the S&P500 for end-2013 would be in excess of 1600.*

S&P500 Operating Earnings have passed an inflection point and will flatten-out before picking up in growth in 2013. In the meantime, the equity market may get shaken-up since flat revenues and declines in earnings growth have often been a precursor to an economic recession and an equity Bear Market. This is an impediment and could be a problem until higher earnings growth off the new approach to monetary policy by the Federal Reserve can be seen.

Strategically More Bullish Stance on Equities as an Asset Class

As a result of QE "Open-Ended," the U.S. Strategic Broad Asset Allocations have been adjusted as follows:

- Equities: *increased* to 65% from 60% (55% neutral). This is a clear and Solid Overweight. Repeated injections of monetary stimulus support a bullish view for Equities.
- Fixed Income: *decreased* to 30% from 35% (35% neutral). Fixed income is a Slight Underweight now, as a Fed committed to extremely low interest rates through mid-2015 suggests a stronger economy, eventually higher inflation, and higher long-term interest rates.
- Cash and Equivalent: *held* at 5% (10% neutral). Safety of principal still a concern, but this asset class offers little or no returns and this is very unattractive. Dividend-yielding stocks *are* attractive.
- Alternative Assets: *held* at 5% with an upward bias. Overweight on Commodities—including Gold as a store of value.

Table 1
S&P500: Fair Value Estimates

	Prior	Current	End 2012	End 2013
Baseline	1400-1425	1475-1500 (range: 1400 to 1550)	1490- 1540	1600-1650

Source: Decision Economics, Inc.

Tentative Sector Allocation Changes

There are also implications for Sector and Industry allocations from the Fed action. Some tentative changes include:

- Higher weights to Consumer Discretionary and Staples and Industries related to housing as monetary easing filters through to household balance sheets, lifting sentiment and consumer spending.
- Higher weight to Financials as the housing market recovers and Major Money Center Banks benefit from increased loan activity. *DE has had a Housing Recovery and Expansion macro top-down investment theme for 20 months.* As residential real estate recovers, regional banks will gain; also from an expected (by DE) steepening yield curve.
- Lower allocation for Energy (now Equal Weight with the market) and Health Care (still Overweight, but less so).

Global-Regional and Country Allocations

For Global Asset Allocations, most will remain largely unchanged. However, countries that stand to benefit from higher inflation and commodity price-driven exports are more attractive. These tend to be Developing Countries.

Table 2
Tentative Changes in DE Asset Allocations on the New "Open-Ended" QE

Asset Class	Current Weights and Changes		Commentary
Equities	**Solid Overweight**	**65%** (from 60%)	Relatively good earnings and extraordinarily low interest rates expected for a long time. More QE by numerous central banks and low short-term interest rates support higher valuations. *Macro risks and shocks to forward earnings remain a concern moving forward.* Reactions by business to the European downturn, "Fiscal Cliff," and the U.S. Election are very uncertain. New plus is a turning to easier monetary policy around the globe.
Fixed Income	**Slight Underweight**	**30%** (from 35%)	Long-term interest rates and inflation expectations typically turn up in a business upturn, but so far have not. Short-term interest rates set at or near zero will be anchored there until the unemployment rate is a lot lower, but then long-term interest rates should rise. U.S. federal budget deficits and public debt are a big risk, with parameters Japan and Eurozone-like. But, there is little chance of another Crisis given safe-haven flows. Tight credit spreads should remain, given strong corporate balance sheets and the U.S. economy upcycle.
Cash & Equivalents	**Underweight**	**5%** (unch)	Safety of principal remains a big deal. More reaching for risk and return can be expected as time passes.
Alternative Assets	**Equal Weight**	**5%** (unch)	Bullish allocation to Gold continues, with uneven movements expected, supported by its status as a currency substitute, hedge against inflation, and history as a store-of-value.
Sectors (Equities)	Favor Consumer, Housing, Financials		Upgrades: Consumer Discret., Staples, Financials Downgrades: Energy, Health Care, Info Tech
Sectors (Credit)	Top-quality Corporates favored. Spreads to Treasuries narrower.		Companies' cash position and balance sheets are the best in decades.
Country and Global Regions	Maintain Relative Underweight on Europe. Overweights Asia ex-Japan, Emerging Markets, North America.		Upgrades to countries that stand to benefit from commodity-price driven exports.
***** *"Neutral" is 55/35/10 for Equities/Fixed Income/Cash;" 5% Alternative Assets at discretion of investor***			

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