Strategic Insights

May 2011

Its About To Get Interesting

Record amounts of stimulus and government spending have helped orchestrate an almost 90% rally in equities, returning prices to near pre-crisis levels. The stimulus required a record amount of new government debt, and increases the probability of run- away inflation. Despite the efforts, we still find ourselves in the slowest post WWII economic recovery on record.

Now that stimulus is set to end on June 30, 2011.

Money Printing, Liquidity Pumps and Quantitative Easing: How We Got Here

In an attempt to fight a free falling economy and financial markets, the Federal Reserve lowered the Federal funds rate to 0% to .25% in December 2008. Confidence in the economy continued to spiral with the S&P 500 falling another -20% by he end of February 2009. Since they had obviously run out of room to stimulate the economy further through lower interest rates, the Fed initiated the first round of what it deemed "Quantitative Easing" in March 2009. The plan was simple: by purchasing large amounts of treasury securities in the open market, QE had the effect of lowering interest rates below zero, producing a floor in financial markets and encouraging risk taking.

QE1 did achieve one objective. By effectively creating negative interest rates, investors had little choice but to move money out of negative returning cash and money market accounts back into equities and financial instruments. Stocks benefited substantially from QE1. The first round of quantitative easing ran through March 31, 2010. Unfortunately QE1 did not have a similar im-

pact on the overall economy, housing prices or most importantly: *jobs.*

Had QE1 and the enormous fiscal stimulus implemented by Congress generated an average post World War II recovery, there would have been no need for a second round of quantitative easing. Four weeks after the end of QE1 volatility returned to equities. Weak economic news, May Flash Crash, and Ireland threatening a sovereign debt crisis in Europe gave investors a -15% decline in the S&P over the summer.

At his speech in Jackson Hole Wyoming on August 28, Fed Chairman Ben Bernanke stated:

> *"At their most recent meeting, FOMC participants observed that allowing the Federal Reserve's balance sheet to shrink [remove the quantitative easing] in this way at a time when the outlook had weakened somewhat was inconsistent with the Committee's intention to provide the monetary accommodation necessary to support the recovery. The majority of the Federal Reserve members issued an insurance policy on the recovery."*

The conversation from the Fed about "exiting the unusually accommodative monetary policy" was replaced with hints of another round of Quantitative Easing. After all, if the first 750 Billion of tax payer money didn't do the trick, maybe the next round of $600 Billion will. The Fed's second round of quantitative easing included purchasing $600 billion of Treasury bonds by June 30, 2011 "to promote a stronger pace of economic recovery and to help ensure that inflation, overtime, is at levels consistent with its mandate."

The result of the incredible liquidity and constant buying by the Fed is undeniable for stocks. The chart below shows the S&P 500 stock index during QE1 and QE2.

Pumping the Markets or Pumping Inflation?

While the incredible rally in equities is welcomed by investors, the fuel for the rally does not come without consequences. The onset and continuation of QE2 has spurred debate and some dissension within the Federal Reserve, since it was announced last August and implemented in November. The Fed has been concerned since 2008 that inflation was too far under its inflation target of 2%, elevating the risk of deflation. Somewhat ironically, the dissenters within the Fed have been more concerned that QE2, and the further expansion of the Fed's balance sheet, would push inflation above the Fed's 2% target.

Fed presidents – Charles Plosser of Philadelphia and Richard Fisher of Dallas – have lobbied to end QE2 early and not spend the full $600 billion. On March 31, Narayana Kocherlakota, president of the Minneapolis Fed said he expected core inflation to rise to 1.3% by year end, up from .8% at the end of 2010. Citing the Taylor Rule, Kocherlakota said the Fed would have to raise the Federal funds rate by more than the increase in core inflation, or by .75%. Both Plosser and Fisher have also suggested they would favor raising rates in the near future.

Other regional Fed presidents are more sanguine about inflation and are still concerned about the fragility of the recovery. Janet Yellen, from San Francisco and Sandra Pianalto, from the

Cleveland Fed continue to believe the excess slack in the labor market will keep wage increases in check, while the surge from commodity inflation will prove temporary. Theoretically, all 12 Federal Reserve regional presidents are equal. However, William Dudley, president of the New York Fed, is first among equals. It is noteworthy that after the Labor Department announced a 216,000 increase in jobs for March, Dudley said the U.S. is still "very far away" from where policy makers want to be. This view is also shared by Federal Reserve Chairman Ben Bernanke, and is why the Fed is committed to completing its $600 billion of Treasury bond purchases through June 30.

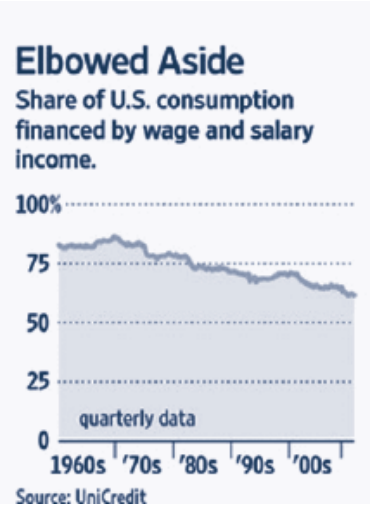
We think the majority of Fed regional presidents and permanent members of the Federal Open Market Committee want to wait as long as possible to assess the sustainability of the recovery. Ending QE2 amounts to a tightening of monetary policy, even if the Fed continues to hold the Fed funds rate at 0% to .25%. The end of QE2 is not the only headwind challenging the sustainability of the recovery.

Hidden US Inflation

Energy and food inflation is the worst kind of inflation. It is unresponsive to monetary policy, since the Fed can't increase the supply of food or oil. It also depletes disposable income, so consumers have less money to spend on everything else. In an environment of weak overall demand, this is not good.

The increase in food prices is likely understated since many food companies are cutting the size of their packages by 10% to 15%, rather than raising prices. For instance, Nabisco's Fresh Stack package of saltine crackers contains 15% fewer crackers than the old package. Chicken of the Sea albacore tuna now comes in 5 ounce cans instead of 6 ounce cans. Many canned vegetables now only hold 13 ounces, down from 16 ounces, with some cans of corn only holding 11 ounces. Bags of sugar have shrunk from 5 pounds to 4 pounds, while containers of baby wipes hold 72 wipes, rather than 80. Higher prices shrink consumer's purchasing power. Although shrinking packages may not show up in the CPI, consumer's purchasing power is being squeezed as they buy more packages to feed their families.

If the consumer price index was weighted today as it was in 1992, CPI inflation would be pushing 10%, according to the Shadow Government Statistics website.



American Incomes Being Squeezed

No matter which inflation metric is used, the average worker's income is not keeping up with the cost of living. Census Bureau data shows the median or typical household has experienced an inflation adjusted decline of 5% in household income since 1999. During the 1960's and the first half of the 1970's, 77% of consumption in the U.S. was financed by wage and salary income, according to the Commerce Department. Since then, it has drifted down to just 64% in 2010.

Remarkably, while wage and salary funded consumption was declining, consumer spending as a percent of GDP rose from 62% to 70%. This increase in consumption was funded by a large increase in household debt. As we have noted many times, household debt as a percent of GDP soared from 44% in 1982 to 98% in 2007. The increase in consumption was also funded by a significant increase in government-backed income transfers (unemployment benefits, social security, disability insurance, Medicare, Medicaid, veteran's benefits, etc) from just 8% in 1970 to almost 18% in 2010. As we mentioned last month, if it wasn't for the almost $1 trillion in government income transfers made possible by increasing federal debt by $1 trillion since December 2007, disposable income would be 4.6% lower, rather than up 4.0%.

According to the Labor Department, there are 24.6 million households headed by people aged 65 and older. Most of these folks spent their lives working, raising families, and saving a little from their paychecks. They are risk adverse and dependent on the income from Certificates of Deposits and money market funds. As of January, the average interest rate paid on these relatively safe vehicles was .24%, the lowest on record dating back to 1959. Americans have $3 trillion in money market funds and $5 trillion in savings accounts. Compared to 2007, the loss of interest income amounts to $350 billion a year, according to Crane Data. One-year CD rates have plunged during the last 3 years from 3.63% to .53%, and Bankrate.com estimates this translates into a loss of $41 billion a year for savers.

Global Inflation Fight Already Started.

The European Central Bank raised interest rates from 1.0% to 1.25% on April 7 because their CPI has risen to 2.6%, well above their target of 2.0%. In Spain, more than 90% of mortgages are tied to short-term rates. Each .25% increase by the ECB will add $475 to the average Spaniard's annual mortgage payment. The increase in rates is also pushing the Euro higher, making exports more expensive. This hurts Germany and the other countries within the EU that rely on exports to boost domestic GDP. We believe another chapter in the European sovereign debt crisis will be written in coming months. The ECB will do everything in its power to postpone the day of reckoning. We don't think they will be successful.

China has increased interest rates four times since last October, most recently on April 6. The benchmark one year rate is now 6.31%. On April 17, the Peoples Bank of China increased reserve requirements to 20.5%. It is the tenth time they have increased reserve requirements since the beginning of 2010. Despite these increases, overall inflation reached 5.4% in March, while food prices are rising at almost 12% from a year ago. In early April, the National Development and Reform Committee squashed a planned increase in food prices by Unilever, concerned that public alarm over price increases would intensify. Chinese shoppers cleared supermarket shelves of soap, shampoo, and laundry detergent after reports Proctor & Gamble planned to increase prices by 5% to 15%. The average worker in China earns less than $4,000, and spends more than 40% of their income on food, which makes Chinese consumers very sensitive to higher food prices.

Rising real estate prices is another challenge for the Chinese government, since the average worker can no longer afford even a small apartment in many of the large cities. In Shanghai, the average apartment sells for $500,000, and in second-tier cities like Chengdu, a typical homes sells for 25 times average income. In the U.S., median home prices in 2006 were 4.6 times median income, which looks cheap relative to prices in China. In the first quarter of 2011, real estate investment soared 37% from last year. As it slows in coming quarters, China's GDP will slow.

In India, the Ministry of Commerce and Industry reported that the wholesale price index for food rose 8.74% from last year. On May 3, the Indian Central Bank increased interest rates by 50 basis points to battle inflation. "Current elevated rates of inflation pose significant risks to future growth. Bringing them down, therefore, even at the cost of some growth in the short run, should take precedence," Reserve Bank of India (RBI) governor Duvvuri Subbarao said.

In Brazil, the annual inflation rate climbed to 6.44%, up from 5.91% at the end of 2010. On April 20, the Brazilian Central bank raised its benchmark rate to 12.0%, the highest rate in the world.

In response to the financial crisis in 2008, every major central bank across the globe aggressively lowered interest rates, and most countries pushed through large fiscal stimulus plans. The increase in inflation is causing many central banks to reverse their monetary accommodation. The first few increase in interest rates are merely moving monetary policy from accommodation to neutrality. In recent months, the countries with the strongest economic growth and highest inflation rates have begun to shift monetary policy from neutrality to tightening. The tightening of monetary policy usually takes 6 to 9 months, before the drag on economic growth appears. This suggests that growth in China, Brazil, and India will taper off in the second half of 2011 and early 2012. The slowdown in these fast growing economies will feed back into the developed countries, acting as a drag on their growth in the second half of 2011 and early 2012.

After Record Stimulus Spending, Where are the Jobs?

Of the prior 11 recoveries since World War II, job growth has never been so weak, with more than 5% of the labor force still unemployed 39 months after the start of a recession.

The Bureau of Labor Statistics changed its definition of who counted as being unemployed during President Clinton's first term. The BLS decided to exclude long term discouraged workers from the unemployment rate calculation. This is particularly relevant in this recovery since 45.5% of the unemployed have been out of work for more than 6 months. If the old definition was used – which included both short and long term discouraged workers, and added in the regular unemployed workers as well, 22% of Americans don't have meaningful work, according to the Shadow Government Statistics website. The Gallup Poll's measure of unemployment combines the unemployed, with part timers seeking full-time work. In March, it rose to 19.9% from 17.2% in December.

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The important point is that the labor market is far weaker than the 8.8% official unemployment rate suggests. It is no surprise that consumer confidence remains at levels that have only occurred while the economy was in recession.

Stock Market Outlook

While the economy has yet to benefit substiantially from Quantitiative Easing, there are some positive outcomes. Corporate earnings have been good, balance sheets are strong, and costs are held down as companies refrain from hiring. Companies with international exposure have fared better, since many parts of the world are growing faster than the U.S. Companies in the S&P 500 derive more than half of their sales abroad. The rally in the market and solid corporate earnings hasn't gone unnoticed, with bullish sentiment now reaching levels not seen since October 2007. However, the market doesn't go down because people are bullish. In the short run, the combination of an improving economy, rising profits, and bullish sentiment keeps selling pressure low. No institutional money manager is going to do much selling if they think the economy is going to continue to improve. As we have noted many times, the rally since March 2009 has occurred on low volume, which means it has been supported as much by a lack of selling pressure, rather than strong buying conviction. It doesn't take much buying to lift the market if selling pressure is low.

The market declines significantly when bullishness runs into an economic reality that doesn't justify a high level of optimism. The top in October 2007 was classic. Bullish sentiment was wide spread, while investors thought the U.S. would avoid a recession in 2008, only to be confronted with a financial crisis. We think the market will be challenged in the second half of 2011 and early 2012, when growth slows in the U.S. and globally. In the short run, the market will have to deal with the end of QE2 on June 30. As investors remember, QE1 ended on March 31, 2010 and the market dropped 13.8% in the second quarter last year. Most investors connect the decline to the end of QE1, but that's not the whole story. What investors have forgotten is that Europe's sovereign debt crisis flared up, the Euro dropped by 11% in May and June, which raised concern that another financial crisis was developing.

The perception of many investors is that QE1 and QE2 have been the back bone of the market's rally since March 2009, and once QE2 ends on June 30 the market will decline, just like it did last year. A review of the QE programs sure supports that view. But that perception almost totally discounts the improvement in the global and U.S. economy that has occurred since mid 2009. However, the fact is that investors will act on their perception of the end of QE2, which suggests they will not wait until July 1 to see what happens next.

Its About to Get Interesting

The consensus expects economic growth in the U.S. to accelerate and establish a self sustaining recovery. Despite record amounts of deficit stimulus spending, the current recovery is one of the weakest on record to date. We think tepid job and income growth, lower housing prices, and cutbacks in spending at the federal and state level along with tax increases will slow growth in the second half of 2011 and early 2012. In addition, another sovereign crisis could flare up in Europe at any time, as strains within the E.U. build and tempt Ireland or Greece to break ranks with the E.U. And the tightening of monetary policy in most of the countries that have been growing the fastest will contribute to the slowing in the second half of 2011 in the U.S., bringing the potential of something even more sinister: Stagflation.

All eyes remained focused on June 30, when the markets will once again trade without the benefit of the QE2 permanent buying programs. There is always the chance the Fed will punt, and deliver yet another creative stimulus program.

But the political environment is quite opposite of just one year ago, and the debate in Washington on how and how much to cut the federal budget deficit is just beginning. It appears to us that we have entered the "It's a battle of words, and most of them are lies" stage of the 'debate'. Any deficit reduction will influence monetary policy. The more front loaded the deficit reduction is, the more likely the Fed will feel compelled to offset the fiscal drag from deficit reduction by maintaining a greater measure of monetary accommodation. It is unlikely Congress will have arrived at a deficit reduction plan by June 30.

With stocks and high yeild bonds priced near perfection, the absense of permenent Federal Reserve Purchasing and the threat of global inflation, we believe the second half of 2011 should provide an exceptional environment for Anchor Capital's Absolute Return investment strategies like those managed by Anchor Capital.

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