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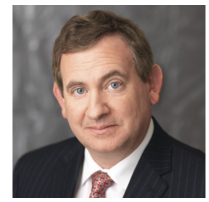
METWEST

TRADING SECRETS June 2013



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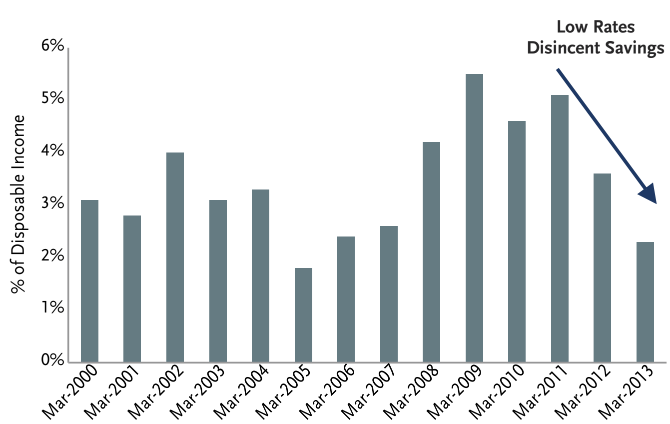
The QE Lemon Has Been Squeezed Dry

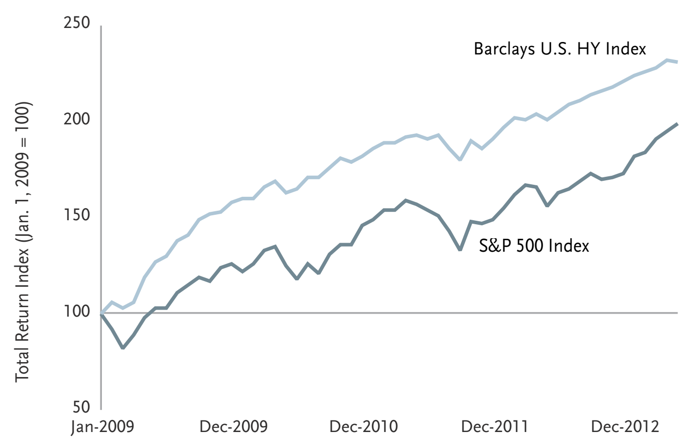
We've just witnessed the dress rehearsal for the end of the Fed's Quantitative Easing (QE). Markets that had learned to stop worrying and love the financial repression have been given reasons to fear the interest rate cycle. For five years we have lived with a central bank that has used, or abused, a zero rate policy and QE to effectuate the Great Risk-On trade to cure the ills of the Great Recession. Wealth has been removed from those with limited risk appetites and been used to reward those able and willing to sponsor the more "speculative" asset classes typified by equities, high yield bonds, non-agency MBS, and EM debt.

An essentially Keynesian Fed has used negative real yields to manage the savings rate down and catalyze portfolio reallocations out of cash thereby sending higher the prices of stocks, bonds, and real estate. These, however, have been mere meta-objectives. More wealth per se hasn't been the goal: the ultimate purpose has been to get the dough flowing into the labor market, thereby curing the ills of stagnant wages and high unemployment. Yet, notwithstanding the trillions in QE already done — or perhaps because of the distortions created by it — inflation-adjusted wages collectively earned by the U.S. labor force is right where it was in 2009! While the consumer, the majority stakeholder in the U.S. economy, has experienced some income growth in recent years, that growth has not come from more wages but rather from more government transfers facilitated by more government borrowing. It would seem that the best laid plans of mice and Fed have gone somewhat awry:

Savings Have Fallen Back to Levels Last Seen During the Housing Bubble …



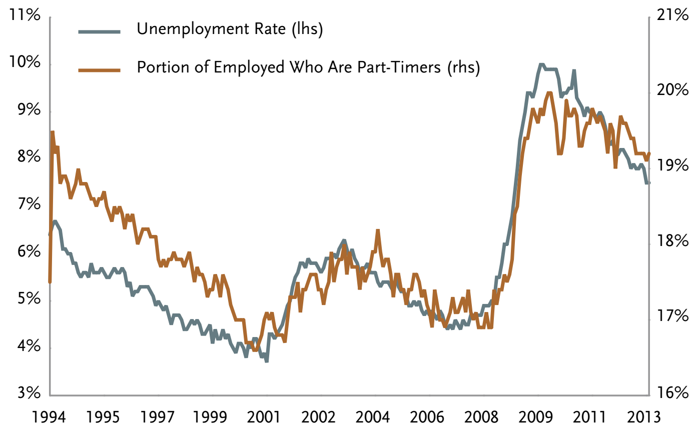
While Asset Prices Are Driven Higher Due to "Risk On" Trade



Sources: Bloomberg, Barclays, TCW

The QE Lemon Has Been Squeezed Dry (cont'd)

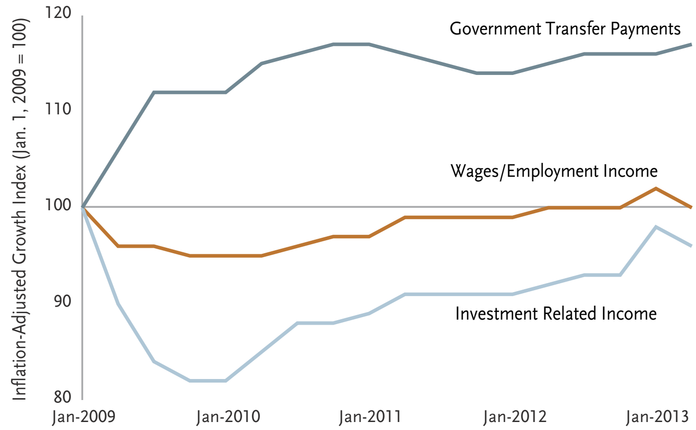
Yet Unemployment is Mired at "Recessionary" Levels …



* Estimated by assuming that the economy can replace 4 part time employees with 3 full time employees.

Sources: BLS, Bloomberg, TCW

And Income Growth Has Been Wholly Dependent on Government Transfer Payments

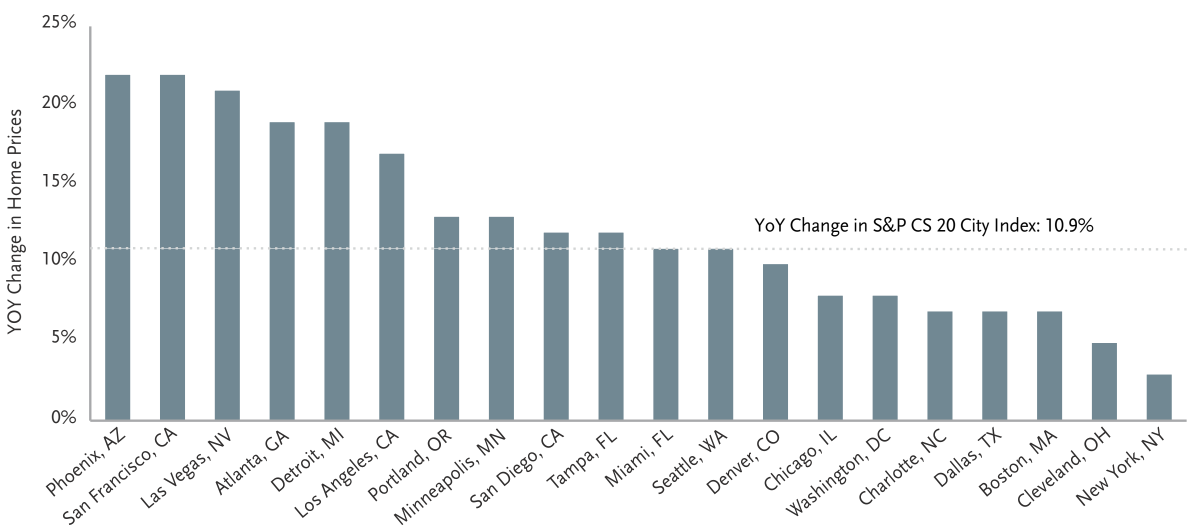


Sources: BEA, BLS, Bloomberg, TCW

So, the Fed has managed up consumption and asset prices, driven down risk premia, yet has not succeeded in its primary objective of increasing wage related income. Why is this? To the Fed's supporters and apologists, the answer is simple: even Ben's "all in" QE has not been able to undo the damage of the financial crisis, abetted by a thinly capitalized banking system, a Euro crisis, a tsunami in Japan, and a housing market that had fallen and could not get back up.

Except that now, housing has not just gotten back up: in many metropolitan areas, housing is doing a jig:

Home Prices Are Posting Gains Across the Country[1]



Sources: S&P Case Shiller, Bloomberg, TCW

1 As of March 31, 2013.

Indeed, with housing prices beginning to gallop, with a banking system far stronger than it was and a Euro crisis that is now so two years ago, you'd think that if the Fed's way of thinking were right, that unemployment rates ought to be plummeting before our very eyes. Higher real-estate prices, sturdy stocks, and abundant and cheap credit "ought" to satisfy the Keynesian pre-conditions for a sustained renewal of aggregate demand. The recovery ordered up from central planning should be coming in for a landing any day now. In effect, the continuation of slow growth with stagnant wages against a backdrop of a recovering housing market is the final test for QE. If the Fed's theory of the recovery is correct, prosperity is now around the corner and so is the end of QE. Alternatively, if real-estate were to continue to run without a proportionate benefit accruing to the labor market, then the Fed is really in a pickle. Would the monetary doves really insist on keeping rates at zero and simply run the risk of launching housing prices into orbit? Doubtful. Rather, higher real-estate prices are either the cure for the malaise or a by-product of fostering portfolio reallocations out of zero percent bank accounts and into real-estate. If so, then the Fed has spawned the very financial imbalances the Austrian economists have warned us about for years. In that event, QE will end anyway, but against a backdrop not of prosperity, but of ongoing economic malaise. If so, the grand monetary experiment of the past five years may prove that extraordinary measures may be appropriate when the economy is in crisis, but a poor tool for taking a weak recovery and making it strong. Printing money does not magically lift worker productivity, increase real wages, or foster technological innovation.

Indeed, traditional market economics is premised on the observation that empowerment of the local micro-economic actors is the key to long-term prosperity. Incentivizing those who have the best information and most reason to "get it right" facilitates the resource adjustment that allows the economy to be "evergreen" and constantly adapting to new conditions. Who is better trusted to price and underwrite a real-estate loan in Phoenix? The local banker who presumably knows something about his local borrower and about the local conditions – or credit officers in "distant" lands taking their cue from central bank policy less concerned about the quality of loans originated and rather more fixated on the quantity of credit created? And while new credit – even in the form of "bad" loans – will goose economic growth today, it does nothing to improve the efficiency of the labor and capital that configures the economy. As such, what growth may come from such distortions is palliative, not stimulative. When inefficient "zombie" companies are kept on cheap-credit life support, how much hiring would you expect from these "yesteryear" businesses? Or, if real-estate prices are soaring and the small business owner is to choose between "investing" in a vacation home or expanding the footprint of his business, he might just choose the vacation home. A nouveau wealth effect may give us a thrill, but if the new wealth contributes little to job creation, QE becomes an exercise in futility.

So, the end of QE is coming into clearer focus. If QE works the way the Fed say it does, higher housing prices will translate into robust job growth ensuring a virtuous self-reinforcing recovery (in which case, QE will end well); alternatively, higher asset prices will further distort the economy, impair job growth, leading the capital markets to conclude that the QE lemon has been squeezed dry (in which case, QE will end anyway – and badly). While we lack the crystal ball to say when – or how – QE will end, we would counsel that now is a good time to take stock of where your capital is allocated. The end of QE will bring many changes, and they will not be painless. Still, to be forewarned is to be forearmed.

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