Washington Crossing Advisors

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Commentary

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The Much Anticipated End Of QE2

Since the Federal Reserve began its large-scale asset purchase program last fall, there has been a widespread and sustained improvement in most of the indicators we monitor. It is difficult to say exactly how much the program contributed to the improvement, but there is at least a coincident relationship between the Fed's purchase of assets and the overall movement of much of the data in recent months. Since last summer, new orders for durable goods have risen faster than inventories, personal spending has accelerated to 2.7% from 1.3%, retail sales are rising 5-6% versus 2-3% last fall, and automobile sales have pushed higher to a 13 million annual run rate versus a 12 million run rate last fall. Risk-taking appetite and liquidity improved as well. Stock markets have generally moved higher, corporate credit spreads have tightened, merger and acquisition activity has picked up, banks appear somewhat more willing to lend, the yield curve has steepened, commodity prices have surged, the trade-weighted value of the dollar has fallen by about 10%, and inflation expectations have moved higher. Importantly, aggregate profits have continued to increase, which is a positive indicator for future investment.

In just over a month's time, the Federal Reserve will wrap up the $600 billion large-scale asset purchase program it began last fall. The Fed, by making these purchases, did several things. It reduced the supply of longer-duration Treasuries available to the investing public, thereby putting downward pressure on private borrowing rates. Lower interest rates, with some modest inflation, reduces the foreign exchange value of the dollar, which helps exports and gives some lift to the inflation rate. Most importantly, by executing on a large-scale debt monetization program, the Federal Reserve demonstrated that a strong link exists between inflation expectations and the size of its balance sheet. Since last summer, the long-run inflation expectation priced into the TIPs market, for example, has risen to 2.4% from 1.5% and commodity prices surged.

The end of this second round of asset purchases has been known for some time. Private banks and other investors continue to buy Treasuries. Yields have moved lower in recent weeks rather than higher, as some feared might happen. What is most important is the fact that there are many other factors in the economy that contribute to how things proceed from here. Keeping a close eye on how the overall economy is progressing is important for maintaining perspective. The dominant theme in recent years has been the drive by the private sector, both businesses and individuals, to improve the position of their balance sheet through a combination of greater savings and lower borrowing.

A Drive to Save

Households are still reluctant to borrow and are more interested in piling up savings and paying down debt wherever possible. It is true that retail and automobile sales are better, but home sales remain sluggish at best. The household savings rate has jumped to 5.5% of disposable income versus 1-2% before the last recession. This de-leveraging of the economy's largest segment is primarily responsible for the disinflationary tendencies that the Federal Reserve is attempting to thwart through aggressive easing of monetary policy.

Profits are the business sector's "savings," and they provide the incentive for private investment and growth. Analysts see S&P 500 companies growing profits 20% over the next year and beyond. Smaller businesses are indicating that sales and profit trends are improving, according to a recent NFIB survey of small businesses.

With improving profitability, there is a better chance that private investment will follow from today's low levels. The pace may be slower than the past, because there are high levels of excess capacity in the economy reflected in a below-average industrial capacity utilization rate and above-average unemployment rate. Both of these measures, however, are moving in a positive direction. Non-residential business investment expanded to 9.9% of GDP from 9.3% last year. This is below the 10-12% typically associated with a well-functioning U.S. economy, but at least the direction is constructive. Much the same can be said about employment trends. The direction appears positive, but there is still a lot of room to go before the recovery can be considered complete.

Government continues to run sizable deficits as an offset to household deleveraging. Add to this the trade deficit, and the combined deficits are enormous. The combined budget and trade deficit as a percent of GDP is 9.5%. Prior to the financial crisis, this figure was in the 1-2% range. From a policy standpoint, this "dis-savings" is the inflationary offset to private sector "savings."

Easy Money and "Transitory" Inflation

The Federal Reserve has maintained a 0-0.25% rate for overnight funds since December 2008. In addition, there has been an additional $490 billion of net purchases of assets by the Federal Reserve since then. According to William Dudley, New York Federal Reserve Chairman, that amount of purchases equates to a 0.5-0.75% rate cut. If so, the rate for overnight funds, after adjusting for net asset purchases, is equal to a -0.75 to -0.25% overnight rate. There is no other country that has been this accommodative. The average refinance rate across the Euro region, for example, is 1.25%. The United Kingdom's base rate is 0.50% and has been recently increased. Canada's overnight rate is 1.0%.

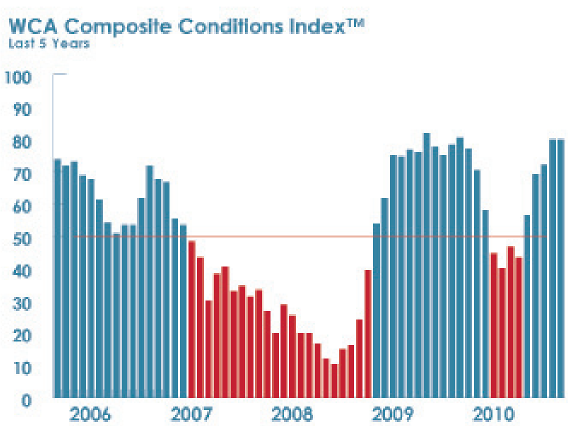
Increasing inflation rates have prompted central banks to begin to take tentative steps toward increasing short-term interest rates in other parts of the world. China has increased its reserve requirements on banks to slow loan growth, the European Central Bank increased its main refinancing rate by 0.25% in April, Canada raised their overnight rate by 0.25% last fall, and recently Bank of England Governor Mervyn King made headlines by suggesting that inflation in the United Kingdom could reach 5% this year.

The growing disparity between the United States' low interest rate stance and somewhat higher foreign rates contributed to a weaker dollar, higher import prices into the United States, a higher consumer price index, and generally higher commodity prices. These dominant trends over the past several months appear to have paused. The dollar has strengthened recently, forecast inflation rates have slipped, and commodity prices have taken a pause in what has been a strong rally in recent quarters. This stronger dollar is exactly what Ben Bernanke would look for to validate his recent claim that inflationary pressures are "transitory."

The last several days' trading is far from a conclusive turnabout in the recovery thesis, however. Last week's stronger than expected employment report is one case in point. A relentlessly weak dollar and higher commodity prices are not a healthy mix for long-run economic stability and growth. For that reason, it is most important to recognize that most of the data supports ongoing expansion in the economy, even if that rate of growth has slowed. Ultimately, we believe slow-but-steady progress is the best possible outcome for financial markets and the global economy. Uncoordinated and erratic growth is a potentially more disruptive outcome.

Portfolio Posture

We are watching the overall picture for financial markets, the U.S. economy, and foreign trade for signs of persistent and pervasive change. Thus far, we have not seen such a change in the data we monitor. Our WCA Fundamental Conditions Index, which measures directional changes in over 30 forward-looking indicators, continues to point toward economic expansion. The index currently stands near 80, which means that roughly 80% of the data we look at is pointing toward conditions that favor economic growth with rising profits. Consequently, recommended portfolios have an above-neutral exposure to equities.



Looking further down the road, it is possible that the economic recovery:

Scenario 1:

The recovery becomes "self sustaining" as private businesses and households become more emboldened by rising profits and improving employment trends. Such an outcome would suggest maintaining or expanding exposure to stocks relative to bonds with a concentration in higher risk categories of both assets.

Scenario 2:

The recovery moderates through the fall. Depending on the pace of moderation, the probability of additional stimulus increases but forecast profit growth and confidence slips. In this case, a more broadly diversified portfolio, with greater balance between stocks and bonds, would be appropriate.

Scenario 3:

The recovery suffers a setback that constricts liquidity and economic growth, prompting concerns about a return to recession. In this case, portfolios will be reapportioned to include a greater exposure to bonds over stocks.

We continue to watch the evolution of the recovery and the formulation of policies that have accompanied the improved conditions seen since last fall. Challenges remain. The European debt crisis has not been fully resolved. There is no clear path to removal of extraordinary stimulus in the United States. China is engaged in a delicate process of attempting to slow loan growth using cumbersome policy tools. The global economy is expanding, but at vastly different rates depending on stage of development. Each challenge is significant and has the potential to interrupt or slow what have been several months of progress. The fact remains, however, that progress has been made compared to what we were seeing several months back. At this time, we see generally supportive conditions (see chart) which continue to support the case for growth. Portfolios are invested consistent with these observations.

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