Viewpoints: The Long Tentacles of Quantitative Easing

Asset Allocation & Investment Strategy

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Many clients have asked our opinion about the recent comments from the Federal Reserve Open Market Committee minutes and Chairman Bernanke's testimony before the Joint Economic Committee and what these may mean for the path of highly accommodative policy environment and, importantly, for the financial markets.

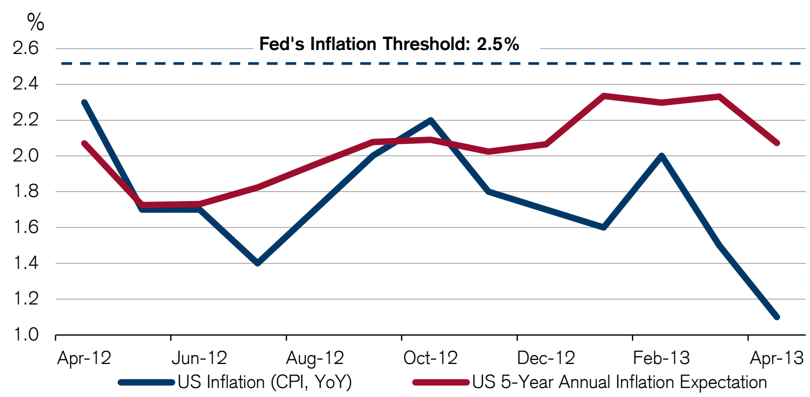
The Federal Reserve is recognized as one of the leading and most important participants in global monetary policy, and its activities have consequences for capital markets, across asset classes, globally. It has been well telegraphed that there have been discussions inside the Fed about the timing of slowing the current $85 billion/month current asset purchase program, known as Quantitative Easing (QE).

Sometimes It's What You *Don't* Say

While Chairman Bernanke carefully chose the words of his testimony on Wednesday, May 22, investors initially inferred that we are near the peak in Federal Reserve bond purchases at least over the short term. While Bernanke did not say that the Fed was about to start tapering its bond purchase program, neither did he say that it would *not* do so. The lack of denial was enough for investors to assume that the Fed will alter its bond purchase program, later if not sooner.

Our economists believe the concerns about an "exit strategy" are premature. Bernanke said explicitly that any decision will be dependent on the incoming economic data.

Figure 1: Inflation Moving away from the Fed's Target of 2.5%
US Consumer Price Index Year-over-Year % change, and 5-Year Annual Inflation Expectations



Source: Bloomberg, Asset Allocation and Investment Strategy
Data as of: 4/30/2013

Keep an Eye on What the Fed Is Watching

We note that two of the Fed's benchmarks for moderating asset purchases, or other types of accommodative policy, are inflation and employment (see Figures 1 and 2).

On both measures, the Fed has plenty of room for friendly policies. Inflation, to start with, has been slowing for almost all of 2013. As measured by the Consumer Price Index (CPI), inflation reached a level of 1.1% in April 2013, which compares to the Fed's target of 2.5%. While the reading should not be seen as deflationary, it certainly does not show signs of sustainable pricing power in economic activity.

With regard to the labor market, the headline level of unemployment has declined to 7.5%, but the slow pace of change has been unsatisfying. In fact, much of the improvement in the unemployment rate has been due to the falling participation rate. On a rough estimate, if the labor force participation rate had held steady over the past two years, instead of declining, the current unemployment rate would have been over 8.5%, thus the labor market has plenty of slack.

We Are Not at the Beginning of the End of QE

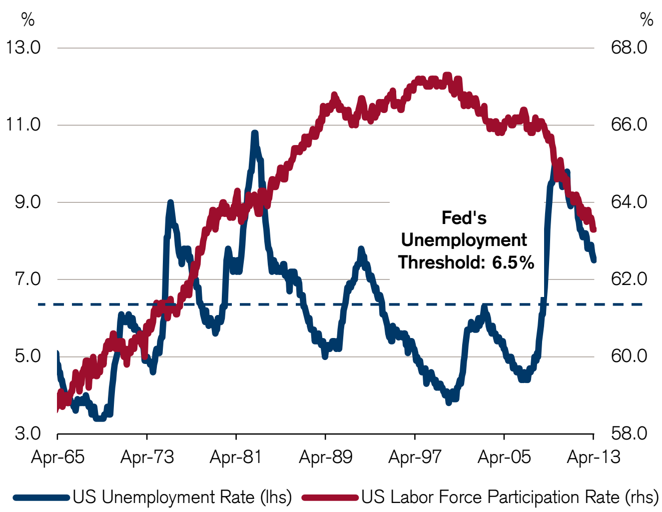
If the employment picture improves, confidence increases in the outlook, and/or if downside risks diminish over the next few months, it would give the Fed the scope to taper its purchases later this year. This is far from an exit strategy. Our economists expect to see a Fed policy that may increase or reduce the pace of its bond purchases over the course of several quarters, or even years, before Quantitative Easing eventually concludes. To use Chairman Bernanke's words: "The Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens." The globally synchronized quantitative easing process has led various assets to show unusual short-term movements, including certain currencies, gold, US Treasuries, and, very recently, the Japanese equity market. For Japanese equities, the combination of rising government bond yields, increased uncertainty from the Fed, and reported weakness in Chinese manufacturing activity, led to the nervous tone in markets and the sharp one-day pullback we saw last week. While it can be shocking to see a 7.0% single-day decline, the move should be put into the context of the almost 40% year-to-date gains in Japanese equities when priced in yen.

What It All Means for Financial Markets

Many fear factors, such as a Eurozone break-up, political gridlock in Washington, or Quantitative Easing-induced inflation, have abated this year. This has been illustrated by many investors' scrambling over the past few months to sell safe haven assets, such as US Treasuries and gold, to buy equities. The pace of gains has been fast and furious in some cases, but as the Credit Suisse Risk Appetite Index (see Figure 3) shows, investor sentiment is not overbought and credit spreads are not signaling imminent difficulties. Although there has been some very recent weakness in selected markets, we view it as profit-taking, and the broader trend for equities remains positive. While bond yields have climbed higher more recently, we would likely need to see much stronger-than-expected economic data for yields to rise meaningfully from current levels in the near term.

Figure 2: Declining Unemployment and Participation

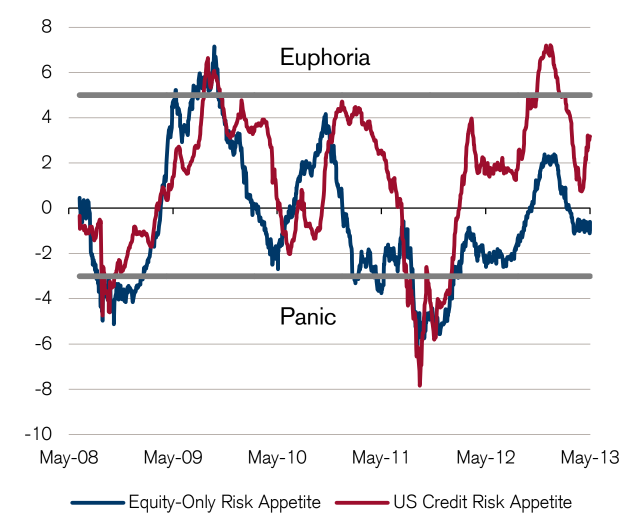
US National Unemployment Rate and the Labor Force Participation Rate



Source: Bloomberg, Asset Allocation and Investment Strategy
Data as of: 4/30/2013

Figure 3: Risk Appetite

Credit Suisse Global Equity and US Credit Risk Appetite Indices



Source: Bloomberg, Asset Allocation and Investment Strategy
Data as of: 5/23/2013

Recent Editions of *Viewpoints*

2013	
May-13	***Don't Put All Your Eggs in One Basket*** Many asset classes have been moving in lockstep, to the downside in 2008 and interconnected through the recovery of asset prices. However, there is an interesting dynamic that has been playing out since the end of 2011: correlations of returns among the broad asset classes to the S&P 500 Index are starting to decline, in some cases, remarkably.
April-29	***High Yield or Low Expectations?*** The erosion of yield in investment portfolios has led investors to place more emphasis on high yield bonds to generate income…In our view, there are four broad points which are quite supportive for the high yield market going forward.
April-15	***An In-Depth Look at Our US Equity Sector Allocation*** The equity market gains have surprised even the most enthusiastic of investors this year, with returns of 8.4% year-to-date for the broadest measure, the MSCI All Country World Index. We continue to favor equities on strategic (6-12+ month) and tactical (1-6 month) investment horizons… Within the US, the dispersion of returns between the top and bottom performing sectors are widening, which can make for a better environment for active investment decisions.
April-1	***The Great Rotation or the Great Frustration?*** Investors waiting for the great rotation out of fixed income into equities are going to have to wait a while longer – a long while, in our view. We do not anticipate large scale losses in fixed income due to rising rates this year, but we do expect returns to be very muted, in the low single digits, at best. On a strategic asset allocation (6-12+ month investment horizon) basis, we expect equities to outperform fixed income, and our favored region/country is the US.
Mar-12	***How to Approach the Equity Market*** One way to soften the ups and downs of the equity market when considering an initial or new investment is to phase-in over a defined time period.
Feb-11	***You Can't Climb Everest without Pausing*** Buying put-options to hedge downside exposure to the S&P 500 Index may be a cost-effective way to protect against short-term turbulence.
Jan-28	***Morning in America*** We are focusing on the return to manufacturing through our US sector weights in portfolios, with a favorable view on the industrial sector and Master Limited Partnerships.
Jan-7	***Beyond the Fiscal Cliff and Why So Many Investors Missed the 2012 Equity Rally*** Why did so many investors miss the equity market rally? The field of behavioral finance describes biases that explain this type of investor behavior. We believe that being aware of these can help investors look beyond them.
2012	
Dec-10	***2013 Investment Outlook*** Our Top 2013 Investment Ideas are designed around our expectation that a low interest rate environment, sustained by moderate growth and inflation globally, will persist in 2013. In this context, we have focused on themes that benefit from a low yield environment, which include: Beyond Cash; Recovery Stocks; Dividends and Beyond; New Gas and Oil Sources; US Real Estate; and the New Hard Currencies.
Nov-7	***An Obama Win - What Now?*** Equities tend to rise between Election - and Inauguration Day, and in the 5th year of a re-elected administration the U.S. equity market average an 8.0% return. We believe the drag from the impact of the fiscal cliff will be manageable.
Oct-23	***Insights from the Credit Suisse Global Wealth Report*** The 2012 Credit Suisse Global Wealth Report highlights timely themes in global wealth distribution including trends of household debt expansion in the emerging markets and global expectations for wealth creation over the next five years.
Oct-9	***Thoughts from the Chicago Wealth Management Conference*** Credit Suisse Private Banking USA held its 6th annual Wealth Management Conference. We hosted a range of thought leaders to help clients navigate the most challenging issues currently facing private clients.
Sep-24	***Making a Run for the Highs?*** The S&P 500 Index is approaching the fifth anniversary of its all-time high of 1,565. Despite healthy 2012 equity gains, we think by some measures markets are more attractive than they were five years ago.
Sep-10	***The Central Bank's Conditional Love*** The ECB revealed additional details of its previously announced bond buying plan that significantly remove tail risk from markets. Sideline cash may be drawn into the market, which could add to the durability of the current risk-on rally.

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