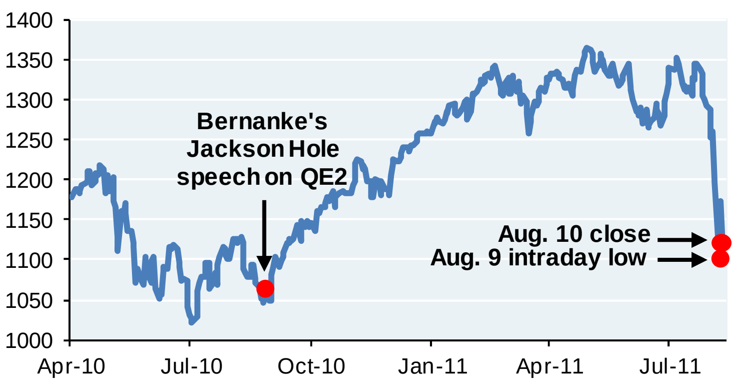
Topics: Fed to keep rates low forever; Shooting the Messenger (S&P); the gold parabola; client call next Monday

Market update: **markets are now pricing in a substantial likelihood of a recession, and a 30% decline in earnings. The real trailing earnings yield of the S&P 500 is around 6.5%, roughly equal to what it was in July of 1982 and January of 2009. This is a terrible way to find oneself at underpriced valuations, but at sub-1150 on the S&P 500, that's where we are. As a result, we are adding to portfolios that are underweight their respective targets. Perfect foresight on the appetite Germany has to risk its AAA-credit rating and provide a massive backstop to Italy and the rest of Europe would be needed to make a valiant call here on a quick market recovery to spring 2011 levels; we don't have it. Please join us on Monday morning on a global client conference call to discuss the market and investment outlook.**

Zerophiliacs. The Fed announced zero policy rates until the middle of 2013, confirming they are "zerophiliacs" at heart. This refers to the belief that zero interest rates can pull forward consumption, help out over-indebted floating-rate borrowers, and force investors into riskier assets. Fed officials like Janet Yellen refer to this latter phenomenon as the "***Portfolio Rebalancing Channel***", and it is, amazingly, the centerpiece of their strategy. Unfortunately, we see limitations in zerophilia. First, as it relates to forcing people into stocks, the fact that equity markets have now reversed most of the gains since QE2 (see chart below) is not going to help the cause. Second, zerophilia has unintended consequences that are worth thinking about.

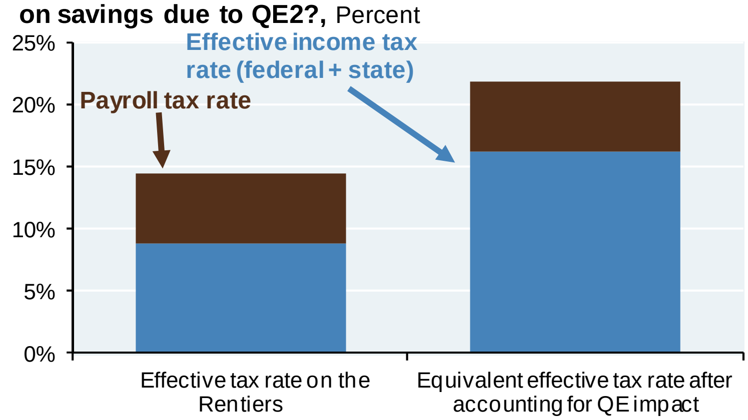
To understand why, consider Mr and Mrs James Rentier[1], an apocryphal family in their early 50's living in upstate New York. The Rentiers are middle income: $80,000 in adjusted gross income, 3 children and $300,000 in savings after setting aside 10% of their income over the last 30 years. Over time, as they aged and given their limited safety net, they shifted their investments into cash and short term fixed income. The current tax system is friendly to the Rentiers; at their income level, after standard deductions, available child tax credits and the payroll tax holiday, their fully-loaded effective tax rate is around 14.5%. But now consider the impact of QE (quantitative easing) on this family. Money market yields, in a normal cycle, are ~ 2% over core inflation; that would be around 3.5% today Zerophilia deprives this family of ~$8,200 per year in after-tax interest income. How substantial is that? Let's normalize interest rates, and then compute the increase in effective tax rates that results in the same amount of after-tax income the Rentiers have today. **As shown below, the punitive impact of QE on this family is the same as raising effective tax rates by one third.** These are the unintended consequences of QE: a wealth transfer from savers to the over-leveraged, and perhaps, to owners of stocks, although this latter channel isn't working that well. Note: this is *before* considering the impact of rising commodity prices on the Rentiers (the Fed rejects the notion that QE affects commodities).

S&P 500 price since April 2010
Level



Source: Bloomberg.

What effective tax rates are equivalent to the lost return on savings due to QE2?, Percent



Source: J.P. Morgan Private Bank, Tax Policy Center, CCH.

There are some heretical critiques of zerophilia, chief among them Jeremy Grantham's "*Night of the Living Fed*" from October 2010. Grantham sees misallocation of resources; unproductive speculation; unrealistic return assumptions by companies, endowments, individuals and pension funds and the consequential excess commitments they make; the impact on commodity prices; and the risk of currency conflict among nations. **The point of all this**: we are no more enticed by the durable prospects of zero interest rates or a possible QE3 than we were by QE2.

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[1] Why are they called the Rentiers? It's a derisive Marxist term referring to people who passively live off their savings. An economist I know once told me that as a CIO, I was a representative of the rentier class when I mentioned concerns about zero interest rates. Other assumptions: earned income grew at 2.5% a year over the last 30 years. Savings invested at a declining spread over prevailing cash rates. Tax obligations calculated using 2011 New York and federal income tax brackets with standard state and federal deductions, use of available state and federal exemptions, and $1,000 child tax credit for 2011 federal income tax purposes. FICA 2011 tax rate of 4.2% for Old-Age, Survivors and Disability Insurance; and 1.45% for Medicare. Sources for tax rates: Tax Policy Center and CCH.

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Shooting the messenger

The WSJ reported this week that there is bipartisan agreement that S&P should be investigated for its "$2 trillion mistake". Politicians reportedly are questioning the motivation for the mistake, and whether S&P could have profited from it. S&P officials may be called on to testify before the Senate Banking Committee. This is a personal view, but I would characterize a lot of this as "shooting the messenger", for the following reasons outlined in more detail last week:

- Even under the revised assumptions that S&P agreed to use, the Federal debt/GDP ratios do not stabilize
- Empirical analysis supports S&P's conclusion about the most divisive US political environment in decades
- The government's assumptions include the revised CBO Baseline used to score the Budget Control Act, which assumes a disappearance of $1.6 trillion in war funding costs that are neither legislated nor binding, and when combined with the Mandatory Cuts in the Budget Control Act, would reduce military spending to the lowest level in 50 years if enacted
- The CBO growth assumptions of 3%-3.6% over the next few years are considerably above recent growth rates, and if growth does not meet these levels, debt to GDP ratios will rise faster than CBO assumes
- The Budget Control Act did almost nothing to change the trajectory of unfunded entitlement costs, which the Federal Reserve Bank of Dallas estimated at $99 trillion back in 2008, an amount roughly 10 times the amount of publicly held debt

If Congress is going to investigate organizations that have expressed dire concern over US federal debt levels and see it as unsustainable, after dealing with S&P, they may need to investigate the following:

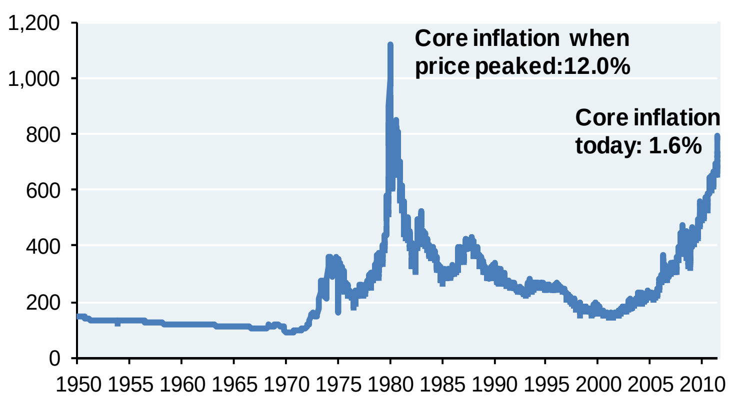
- The Committee For a Responsible Federal Budget (Board members include Bob Strauss, George Voinovich, Laura Tyson, Alan Simpson, Paul O'Neill, Charles Robb, Alice Rivlin, Pete Peterson, William H Gray, Erskine Bowles and various other former CBO members, OMB members and Congressmen)
- The advisors to the 468-page analysis of the budget outlook compiled by Kleiner Perkins entitled "USA Inc." (George Shultz, Paul Volcker, Michael Bloomberg, Richard Ravitch and John Doerr)
- Glenn Hubbard, former Chair of the Council of Economic Advisors, Dean of Columbia Business School and author of "*Toward a Different Fiscal Future: Tax increases can't plausibly address the coming entitlement crisis*"
- Gary Becker (Nobel Laureate, University of Chicago) and Richard Posner (US Court of Appeals for the Seventh Circuit), authors of "*The Looming Entitlement Fiscal Burden*"

The $100 increase in gold prices since the S&P downgrade suggests that Washington (and the President) missed an opportunity to say, "we don't agree with all the assumptions, but that's OK, S&P is entitled to their view, and we are going to do whatever it takes to get it back". Remember the "*Five Stages of Greece*" (EoTM June 30)? Denial is the first phase.

The Gold Parabola

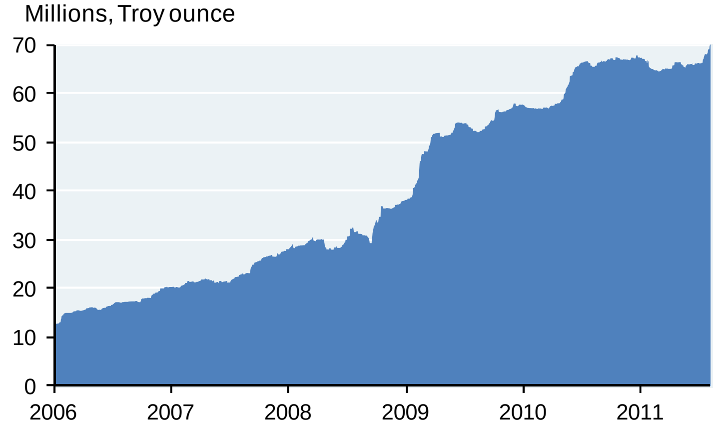
A colleague at J.P. Morgan Chase Bank, Colin Fenton, published a paper predicting $2,500 gold prices this year. Colin's view is a complicated one, as it involves a huge spike in gold serving as a signal to policymakers that something permanent must be done about the long-term fiscal outlook. Such an historic deal would then break the back of gold prices for good, and set in motion a sizable mid-cycle expansion, and a huge rally in stocks. I hope he's right, but based on the first two sections of this note (zero interest rates and a government in denial), the rise in gold is easier to envision than the collapse. A lot has been written about gold; here are two remarkable charts: how the real price of gold has sky-rocketed without the inflationary impetus that drove the gold spike in 1981; and how for all the talk about a gold bubble, ETF holdings haven't even gone parabolic yet.

Inflation adjusted gold price
Dollars per ounce



Source: Bloomberg, BLS.

Total known ETF holdings of gold
Millions, Troy ounce



Source: Bloomberg.

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Colin Fenton's paper: "*What does the US debt downgrade mean for commodities*?", J.P. Morgan Global Commodities Research, August 8, 2011

What the Fed relies on when saying that QE does not impact commodity prices: "*Are Large-Scale Asset Purchases Fueling the Rise in Commodity Prices?*", Federal Reserve Bank of San Francisco, February 4, 2011. The paper looks at commodity price action in the DAYS (not months) around QE announcements. To me, it seems like a paper contrived to arrive at a specific conclusion.

Bernanke wrote an article entitled, "*Japanese Monetary Policy: A case of Self-Induced Paralysis*" in 1999. Here is a quote: "Roosevelt's specific policy actions were, I think, less important than his willingness to be aggressive and to experiment – in short, to do whatever was necessary to get the country moving again. Many of his policies did not work as intended, but in the end FDR deserves great credit for having the courage to abandon failed paradigms and to do what needed to be done".