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November 6, 2013

Market Strategy

Market Commentary/Strategy

To QEternal or QExit, that is the Question: the Case Builds for Tapering Soon

We see a slow 12-month QE taper that starts as early as Dec-2013, consensus sees a Mar-2014 taper that winds QE down in ~6 months. Catalysts are: a counter-productive shrinkage of Treasury collateral, diminishing effectiveness of adding a constant $85B/month to base money, a need to holster QE before using it again, and the historical tendency of post-WW II Fed Chairmen not to leave unfinished business. Stock market volatility typically jumps after Fed transitions, but despite more volatility we see the S&P 500 ending 2014 flat as QE taper lowers the P/E by a percentage that equals the 2014 EPS growth we see, ergo a flat S&P 500. We take our risk with sectors, and since Materials, Energy, Industrials & Technology can do well in the year before the first rate hike we see a window of opportunity as global GDP returns.

As we stated Oct-3, 2013 on Page 5-6, we see a modest QE taper as early as Dec-2013 that lasts a year, versus consensus of a Mar-2014 taper that winds QE down more quickly. We show that adding a constant $85B monthly to the monetary base has diminishing returns **(Exhibit 1)** and if credit creation is the goal there is little utility in removing 80% of net Treasury debt issuance (i.e., high quality collateral) on a run-rate basis by 1Q14E **(Exhibit 2)**. Even if the $40B/mo. Treasury purchases are tapered, we doubt the Fed trims the $45B/mo. MBS QE until 2H14 since net MBS issuance is still negative and past QE rounds did not end until net MBS issuance turned positive **(Exhibit 3)**.

Another reason we see for commencing taper forthwith is a desire to save QE for later use. While the Fed frames its communications in terms of objectives (ex., *"until X% unemployment"*) and time (ex., for a *"prolonged period"*) we use a "builder" analogy and believe the Fed has three principal tools: (1) the "Hammer" of QE, (2) the "Bulldozer" of rate policy, and (3) the "Scaffolding" of Fed-held assets **(Exhibit 4-5)**. We believe the optimal use of the QE hammer - once it is placed back in the Fed's tool belt (tapered) - is to surprise the market to achieve maximal effect. This contrasts with rate policy and stock of assets held, which we believe require more communication to achieve objectives.

In the year before leaving office the eight departing Fed Chairmen since 1948 have uniformly presided over rising policy interest rates and periods of modest stock market volatility. In contrast, the first year of new Chairmen features a wide divergence in rates (perhaps due to the human urge of a new Chairman to "*do something*"?) with spiking stock market volatility, especially the first ~90 days **(Exhibit 6)**. Though the FFR is currently resting on the zero bound, a higher Fed Funds Rate (FFR) has already *de facto* occurred because QE was effectively a "negative" interest rate according to Fed research that has traveled from minus 5% in late 2009 to about 0% currently **(Exhibit 7)**. Given that FFR history may be repeating itself, we believe it is reasonable for investors to expect heightened stock market volatility in 1H14.

Despite the bump in volatility we see 2014 as *"full of sound and fury, signifying nothing."* Our view of a slow Fed taper that starts in Dec-2013 and lasts all year to Dec-2014 serves to lower the S&P 500 P/E ratio (Trailing 12-month, Operating) by ~(9)% from 17x to 15.5x in 2014, in our view, given the correlation between QE and P/E (no such correlation exists between EPS and QE). The Fed is a manipulator of the price of money - interest discount rates - and the P/E is a discount rate (earnings yield). Multiplying our below Consensus 2014 EPS view of +7% y/y (Street view is +10.7% y/y) results in a flat S&P 500 **(Exhibit 8)**. The Materials, Energy, Industrials & Technology sectors typically do well in the year before a rate hike, so we prefer them for a window of opportunity trade 4Q13/1Q14 as global growth returns **(Exhibit 9)**.

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Stifel Macro & Sector Views:

To QEternal or QExit, that is the Question: the Case Builds for Tapering Soon

November 6, 2013

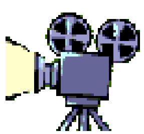
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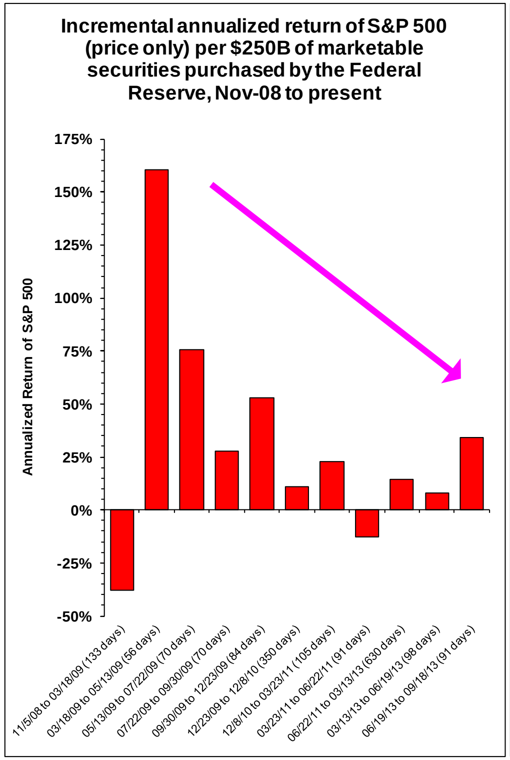
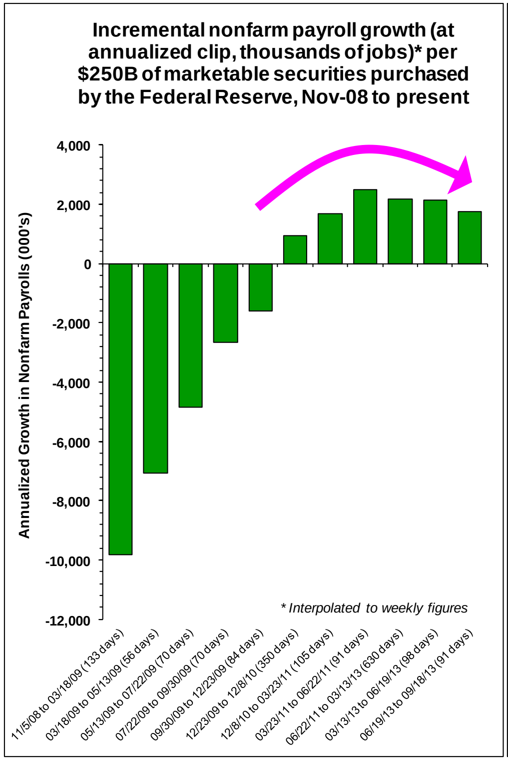
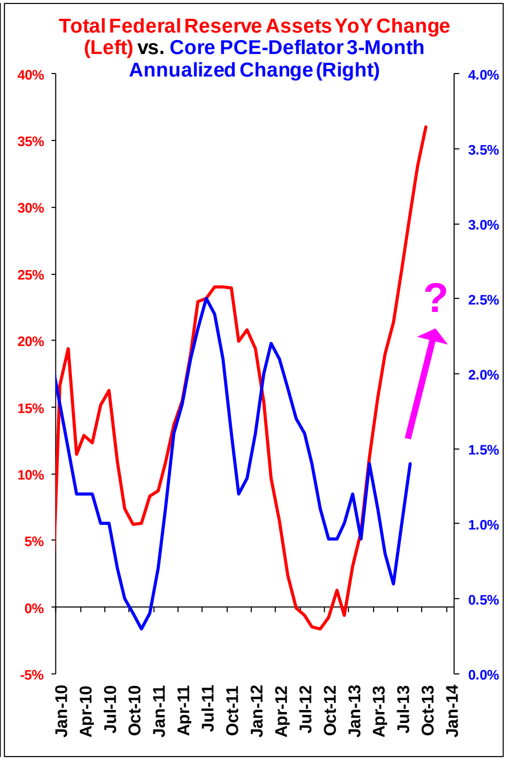
Exhibit (1) – We believe the impact of QE is diminishing, which supports early taper.

S&P 500 annualized gains *per $250 billion* (B) of QE have steadily eroded (left chart), and annualized gains in Payrolls per $250B of QE peaked in 2011 (middle chart). With QE3/3.5 assets *already* on the Fed's books we believe the Fed may choose to step back and monitor whether inflation now rises as expected (right chart).







Source: U.S. Federal Reserve & Bloomberg data. Stifel format.

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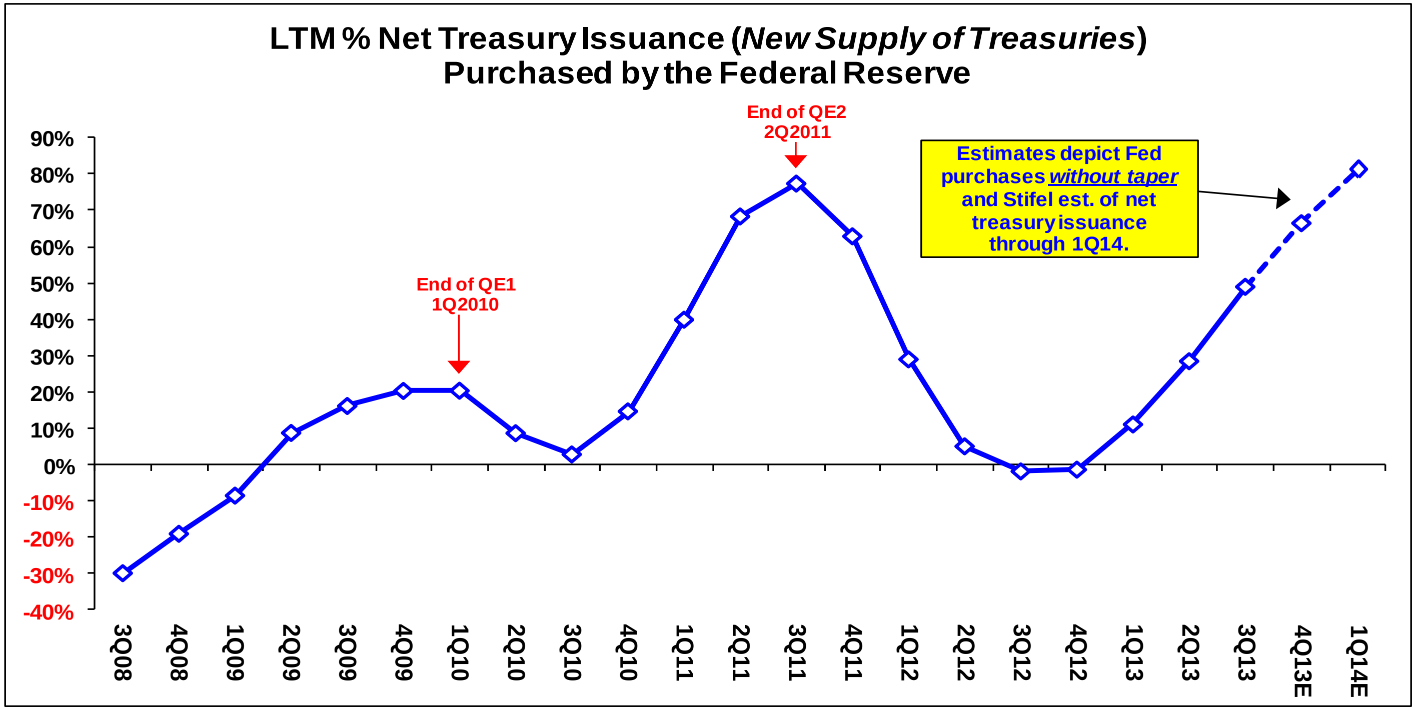
Exhibit (2) – *One catalyst for commencing a taper of the Treasury portion of QE before Chairman Bernanke's term ends 1/31/14 is collateral withdrawal.* The Fed's purchases are removing quality collateral from the system, absorbing 80% of net trailing 12-month (TTM) Treasury issuance by 1Q14E. We believe this supports an early start for tapering the $40B/mo. of Treasury purchases.



Source: SIFMA, Dept. of Treasury, Bloomberg data. Stifel estimates.

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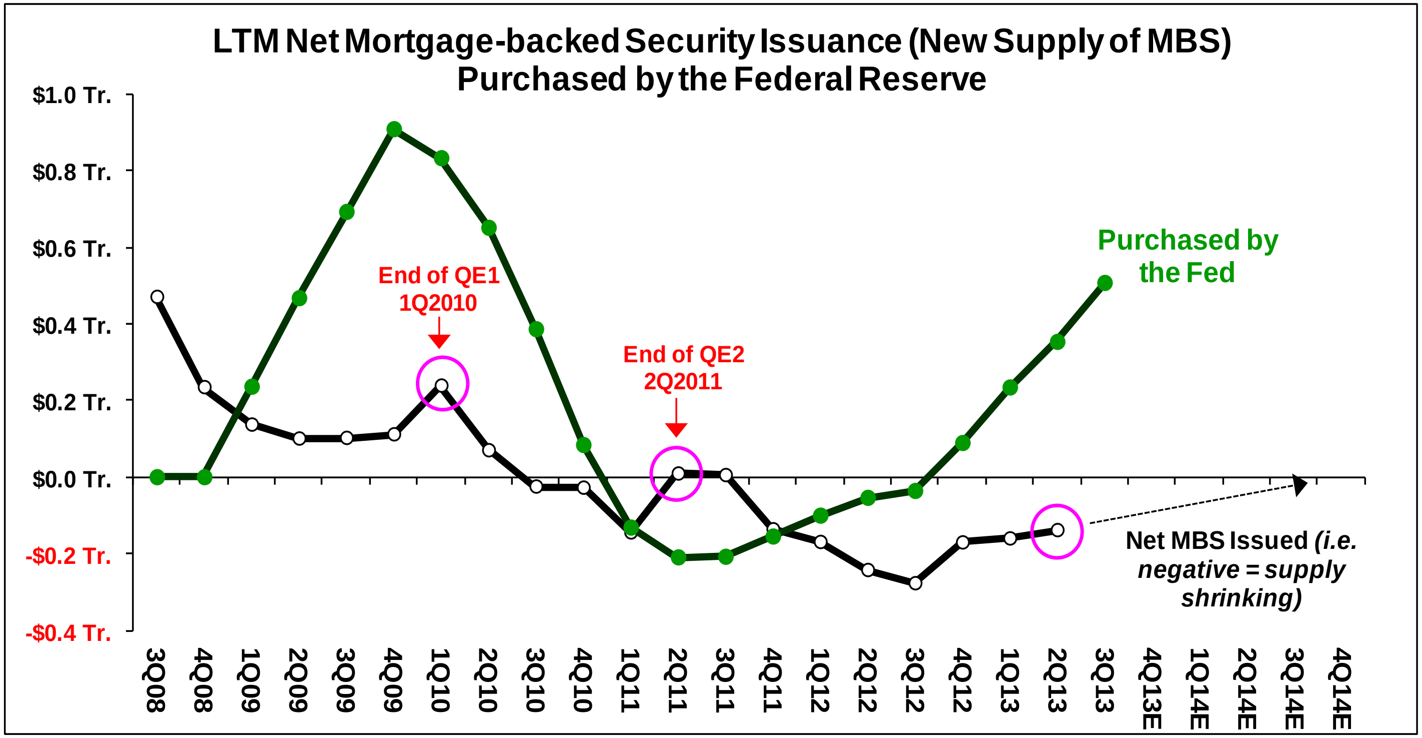
Exhibit (3) – *We would expect tapering of the MBS portion of QE to wait until 2nd half 2014.* MBS purchases are $45B/month but net MBS issuance (black line) is still negative. Since QE1 and QE2 only ended when net MBS issuance turned positive (circles), the Fed may wait until 2H14 to withdraw MBS QE, in our view.



Source: SIFMA, Dept. of Treasury, Bloomberg data. Stifel estimates.

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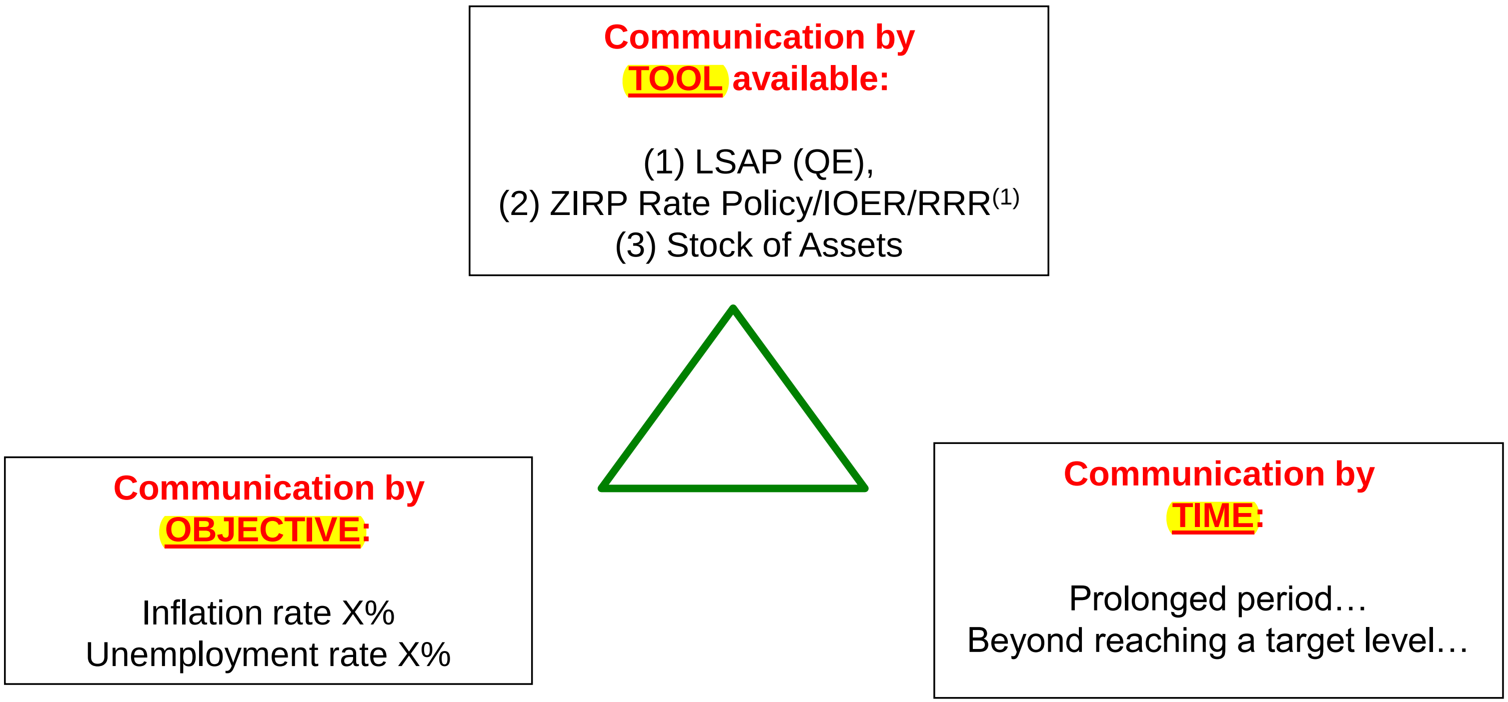
Exhibit (4) – Fed communications error? **The Fed frames communications in terms of objectives (example, "*until X% unemployment*") and time (example, for a "*prolonged period*") but *not* by the type of *tool*, which we believe is an *error*.**



Source: Stifel commentary.

(1) ZIRP is Zero Interest Rate Policy, IOER is Interest on Excess Reserves, RRR is Reserve Requirement Ratio.

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Exhibit (5) - Our view is that QE is more effective <u>without</u> advance Fed communication. **The Fed has three "tools", which are: *(1)* "Hammer" LSAP (QE), *(2)* "Bulldozer" rate policy[(1)], and *(3)* "Scaffolding" Fed-held stock of assets. These tools have different uses <u>and</u> optimal communications strategies, in our view. For example, we have long contended that QE 3/3.5 was effective precisely because it was open-ended and thus *could not be discounted by the market*.**

LSAP (QE) Asset purchases
(Hammer)

Optimal Communication Strategy:
Surprise

Objective of the Strategy:
To control rate <u>volatility</u>

Target 0% rates & Interest on Excess Reserves (IOER)
(Bulldozer)

Optimal Communication Strategy:
Moderate lead time

Objective of the Strategy:
To control rate <u>levels</u>

Stock of assets held on Fed balance sheet
(Scaffolding)

Optimal Communication Strategy:
Sustained with gradual change

Objective of the Strategy:
To flex base money[(2)]

Source: Wikimedia commons, Stifel commentary.

(1) ZIRP is Zero Interest Rate Policy, IOER is Interest on Excess Reserves. We could include Reserve Requirements in rates as well.
(2) Base Money is currency + bank reserves at the Federal Reserve.

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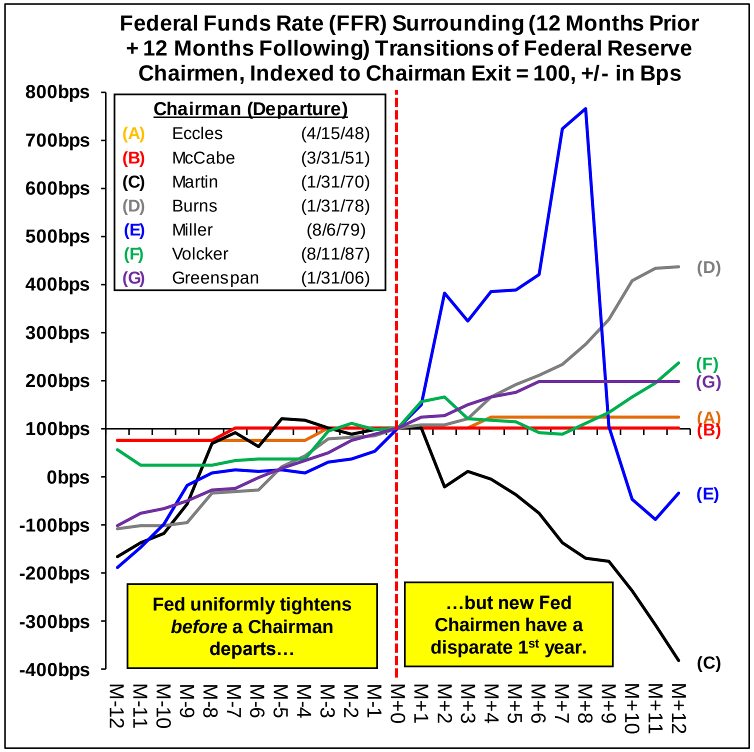
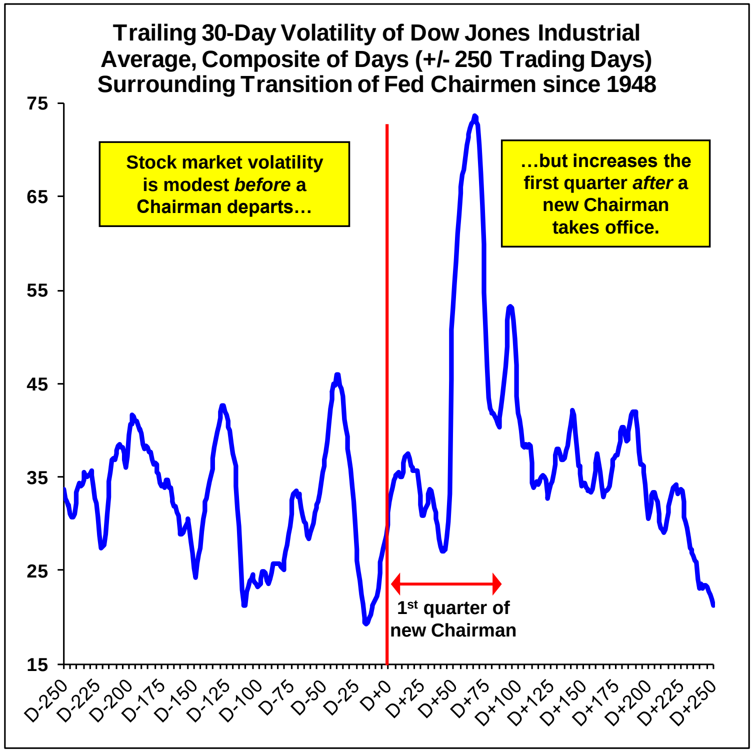
Exhibit (6) - *The year before the exit of past Fed Chairmen has featured higher policy rates and modest stock market volatility, but the year after has greater variance/volatility.* Fed Chairmen since W.W. II (Appendix A) have exited with rising rates[(1)], but *new* Chairmen have been more disparate (left chart), raising stock market volatility the first ~90 days after the new Chairman takes office (right chart).





Source: U.S. Federal Reserve, Dow Jones & Co. Stifel formats.

(1) NY Fed Discount Rate 1/48 to 6/54, Actual FFR 7/54 to 8/82, Target FFR 9/82 to 12/08, Actual FFR 1/09 to present. We acknowledge that the focus of past Federal Reserve Boards was not always on rates (example: Fed research here). We use rates for simplicity as prima facie evidence of policy direction.

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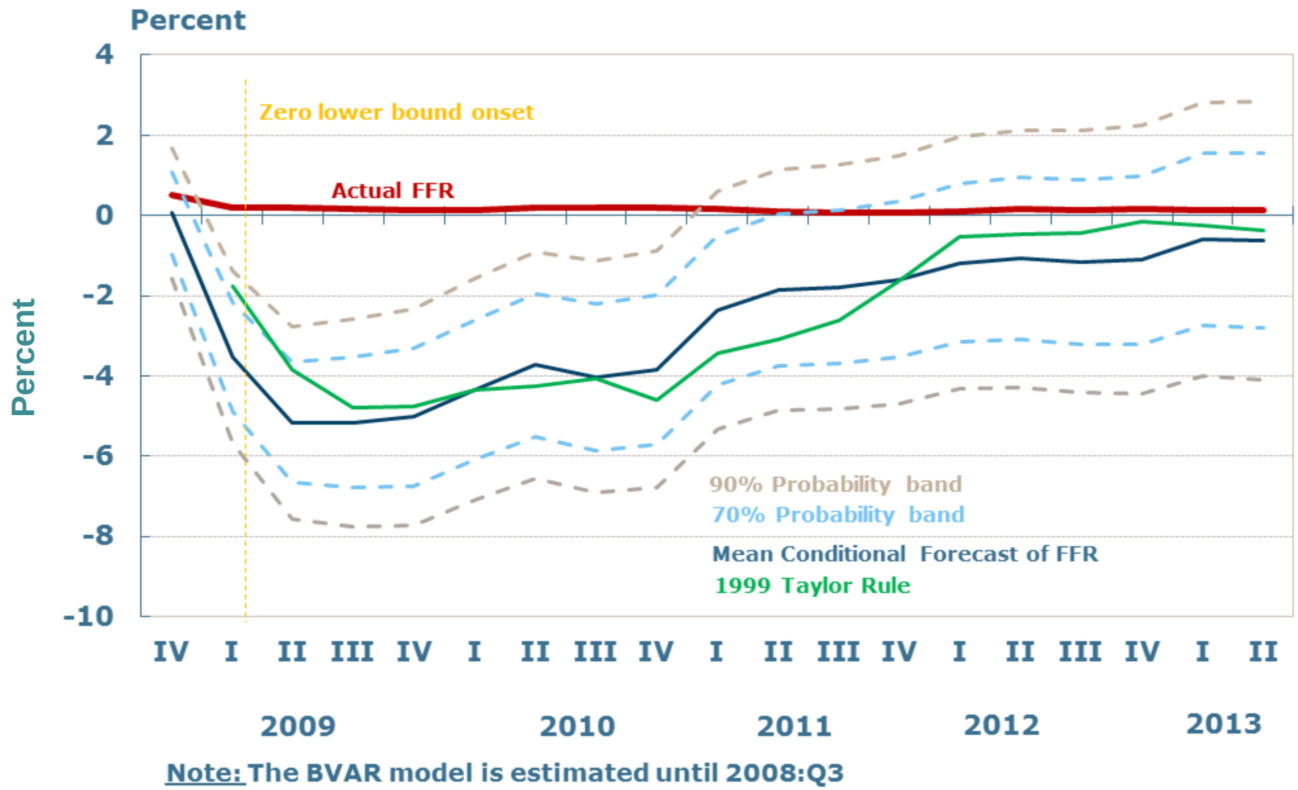
Exhibit (7) – In keeping with the history of past transitions, this Fed has already de facto tightened rates. **As the chart below from a Fed study[1] shows, once rates reached 0% the LSAP (QE) and conditions created a "negative" FFR of -5% in 2009, diminishing as economic & financial[2] variables have recovered, moving toward 0%.**



Source: Cleveland Fed study.

(1) *"Where Would the Federal Funds Rate Be, If It Could Be Negative?"* Cleveland Fed, Oct-2012 here. Chart was updated by the Cleveland Fed upon request.
(2) The empirical model cited above used a Bayesian Vector Autoregressive (BVAR) model with 17 variables to determine an unrestricted forecast of the FFR. As we would expect, financial variables contributed the most to the estimated FFR recovery from a -4% plateau post 4Q2010.

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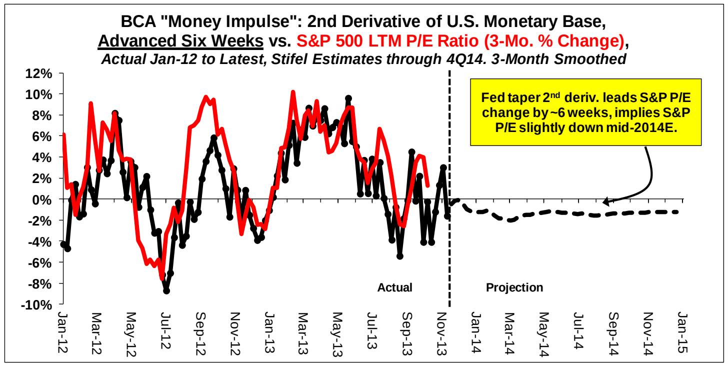
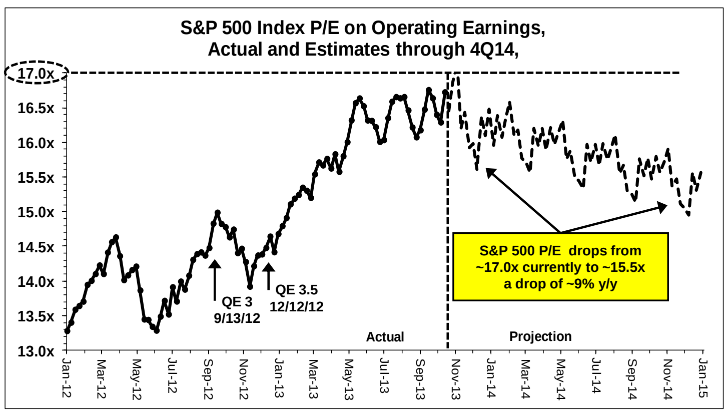
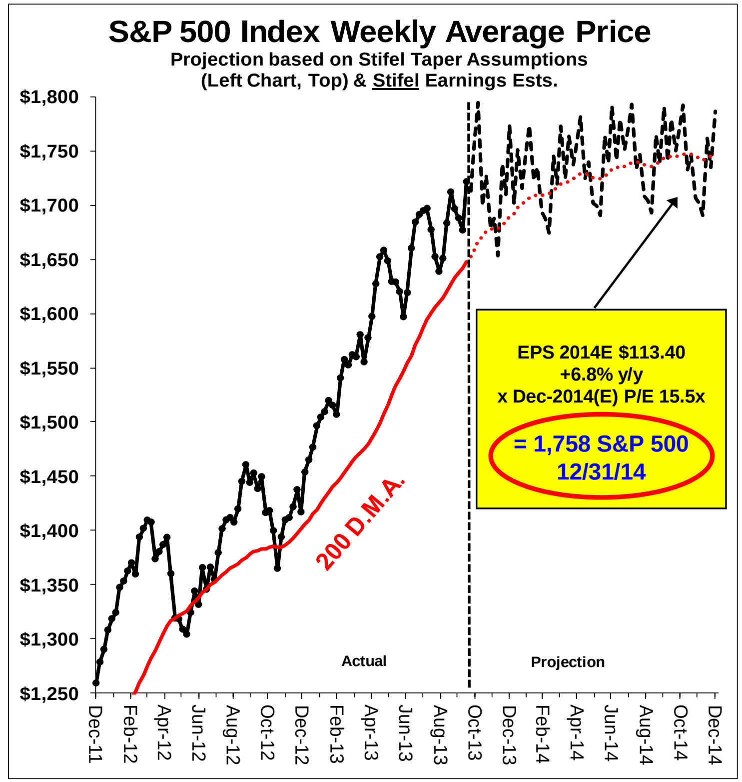
Exhibit (8) - *We see the S&P 500 flattening to year-end 2014.* We see a *slow* Fed taper[(1)] that starts in Dec-2013 and lasts *all year* to Dec-2014 (consensus is a faster taper starting later) that drops the S&P P/E ratio by ~(9)% (left charts). Multiplying *our* below Consensus[(2)] 2014 EPS view of +7% y/y is a flat S&P 500 (right chart).







Source: Standard & Poor's, Bloomberg. Stifel format.

(1) We estimate the Fed tapers $15B Dec-2013, Mar-2014 & Jun-2014, then $20B Sep-2014 & Dec-14 (Timed around opportunities for Fed Chairman to speak).

(2) The consensus bottom-up S&P 500 EPS views for 2013 and 2014 are $107.52 and $121.46, respectively. The consensus top-down 2013 and 2014 EPS views are $106.26 and $113.75, respectively. Taking an average [(top down + bottom up)/2] results in a consensus $106.89 in 2013 and $117.61 in 2014. These figures are close to our $106.16 view in 2013 but above our $113.40 view for 2014.

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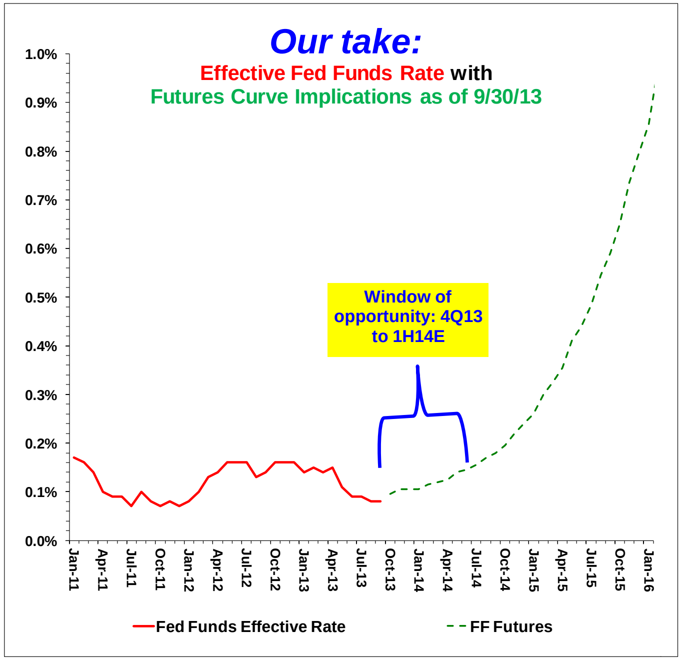
Exhibit (9) - Energy, Tech, Industrials & Materials typically do well in the year before a rate hike, so we see a window of opportunity. **We see a binary outcome: either (a) late-cycle capex and synchronous global recovery take hold, or (b) policy fails, deflation pressures the S&P 500 and Treasury Bonds rally. Seeing signs of economic growth we choose to take our market risk in the four sectors highlighted.**

Ned Davis Research Study

S&P 500 Sector Performance 1-Year Leading Up to First Fed Rate Hike

		SORT 1			SORT 2
Sector	% Gain 252 Days Before	Batting Average (%)	Median Rally (%)	Median Correction (%)	Median Risk/ Reward
Energy	21.2%	88%	32.2%	-10.9%	3.0
Information Technology	21.5%	75%	38.1%	-17.5%	2.2
Industrials	14.7%	63%	27.1%	-9.4%	2.9
Materials	11.0%	50%	27.8%	-14.0%	2.0
Consumer Staples	7.9%	50%	22.0%	-11.1%	2.0
Health Care	8.6%	38%	30.0%	-17.1%	1.8
Telecom. Services	7.2%	38%	21.6%	-13.7%	1.6
Consumer Discretionary	9.9%	38%	20.2%	-16.2%	1.2
Financials	6.4%	25%	22.9%	-14.2%	1.6
Utilities	1.3%	13%	15.9%	-13.3%	1.2

Date of first Fed rate hike: 8/31/77, 9/26/80, 4/9/84, 9/4/87, 2/4/94, 3/25/97, 6/30/99, 6/30/04; based on Fed Funds target rate since 1989, Discount Rate prior. S&P 500 median performance = 12.6%. Batting Average = % of cases outperforming S&P 500, price-only. Sources: S&P Index Alert, Ned Davis Research Group.



Source: Ned Davis Research report (May 31, 2013) *"Rising Interest Rates & Sector Themes"*

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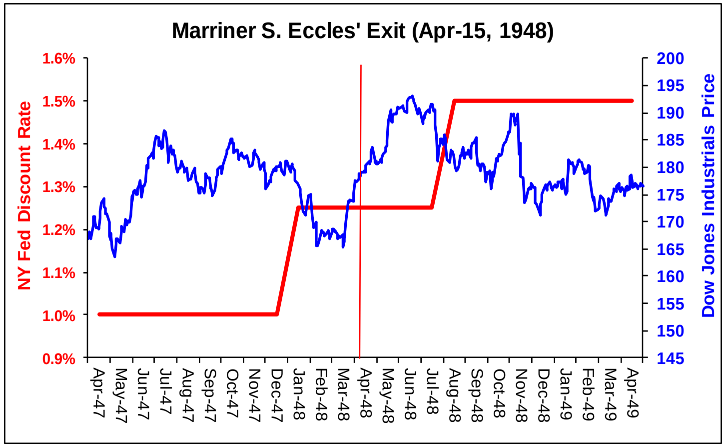
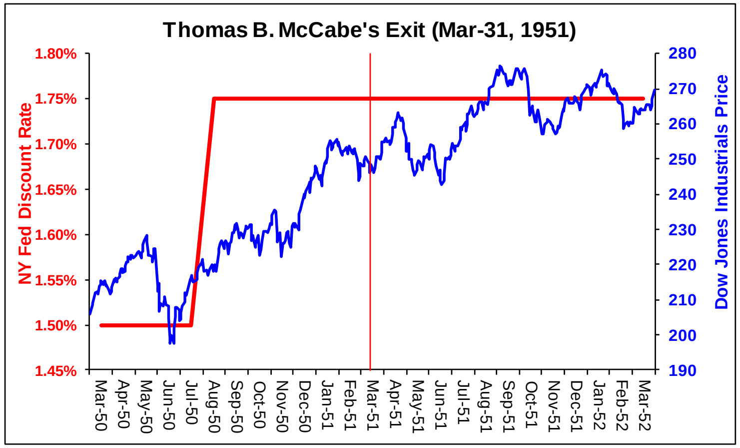
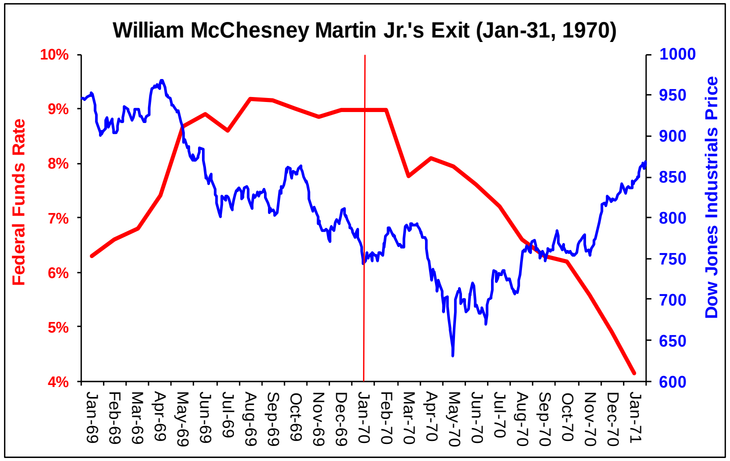
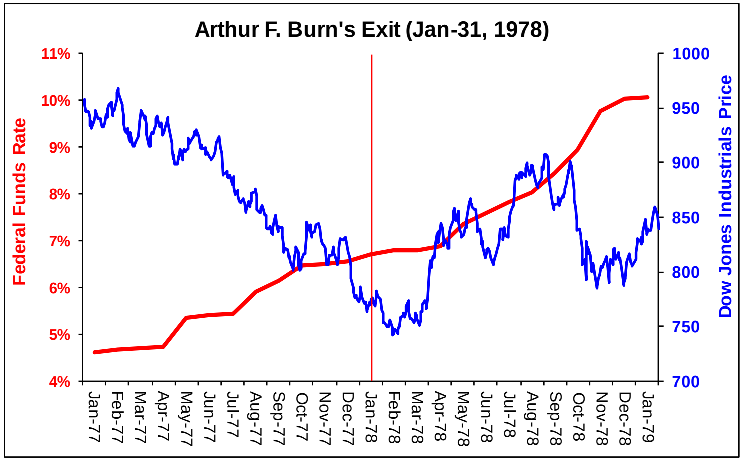
Appendix (A) – Fed Discount/Fed Funds rates[(1)] and Dow Jones Industrials one year before and one year after Fed Chairman transitions since W.W. II.









Source: U.S. Federal Reserve, Dow Jones & Co. Stifel formats.

(1) NY Fed Discount Rate through June 1954, Actual FFR July 1954 to Aug-1982, Target FFR Sep-1982 to Dec-2008, Actual FFR Jan-2009 to present.

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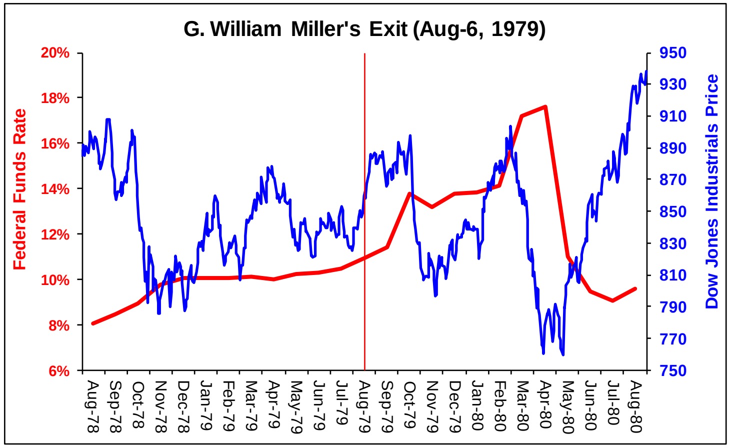
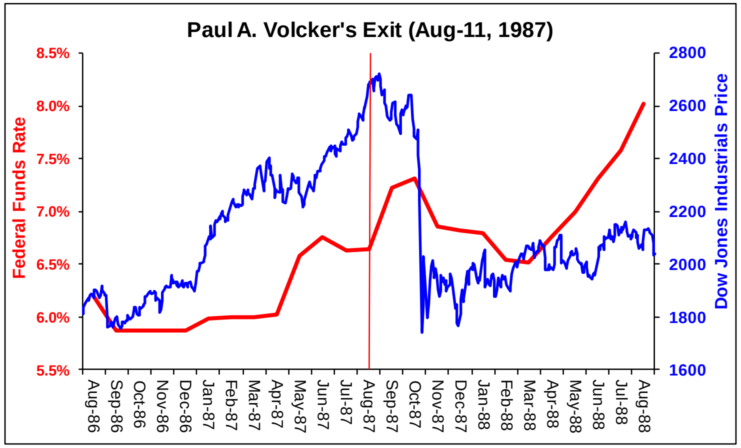
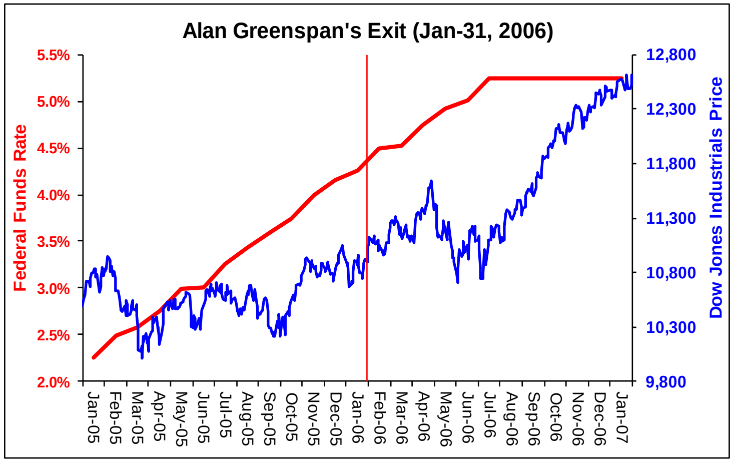
Appendix (A) Continued – Fed Discount/Fed Funds rates(1) and Dow Jones Industrials one year before and one year after Fed Chairman transitions since W.W. II.







Source: U.S. Federal Reserve, Dow Jones & Co. Stifel formats.

(1) NY Fed Discount Rate through June 1954, Actual FFR July 1954 to Aug-1982, Target FFR Sep-1982 to Dec-2008, Actual FFR Jan-2009 to present.

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