Does the U.S. Federal Reserve have us on a collision course?

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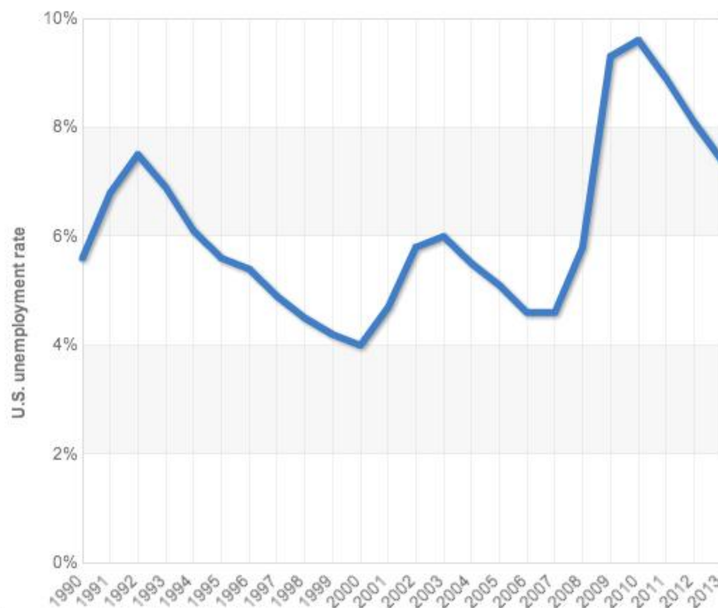
Securities markets continue to be heavily influenced by central bank policy. As we start 2014, the markets are grappling with a policy that is transitioning from quantitative easing (QE) measures to one of forward guidance.

Why are the words “collision course” in the title of this commentary? Because of two issues related to Fed policy: (1) A growing chorus of Fed officials are concerned about financial conditions and the propensity of QE measures to create new bubbles, and (2) The Fed has given guidance about how much influence the labor markets will wield over the fed funds rate, and it has defined a threshold for keeping rates low.

We are now on a collision course with both of these issues. I will look at each issue in a bit more detail, and then I will discuss how policy makers are counting on so-called macroprudential policy to balance the massive liquidity that central banks have pushed onto the financial markets. (This last section is important, because if these policies do not have teeth, we will be left with the same bubble risks that were present during the last 20 years when central banks became too influential.)

The unemployment rate collision

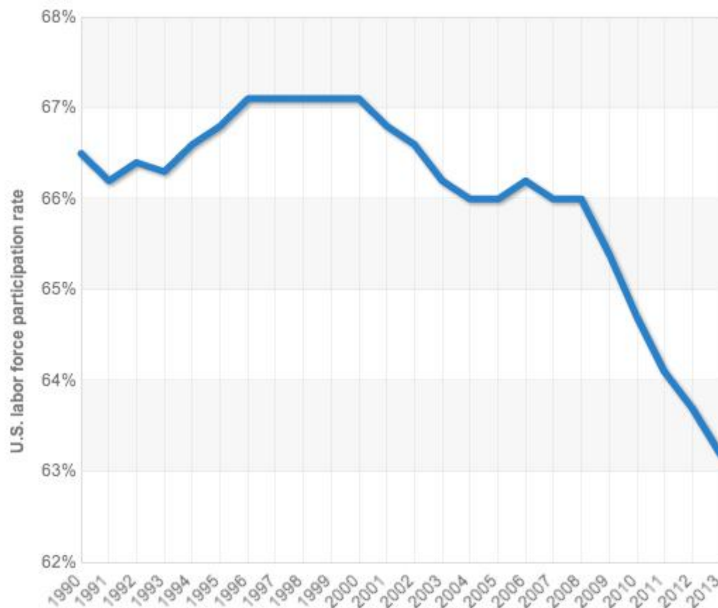
The Fed, under Chairman Ben Bernanke’s guidance, has been using an unemployment rate of 6.5% as a threshold for beginning to steer short-term interest rates away from their zero-bound range (see chart 1).



Data: Bureau of Labor Statistics

The chart above is for illustrative purposes only and is not representative of the performance of any specific investment. **Past performance does not guarantee future results.**

The 6.5% threshold has now become a weight on the shoulders of the Fed’s policy-making board. The labor situation appears to have improved during the last few quarters, but people have been dropping out of the workforce, which has been a sticky issue. This decline in the so-called participation rate (see chart 2) has actually helped lower the official unemployment rate, because it represents the denominator in the unemployment rate calculation.



Data: Bureau of Labor Statistics

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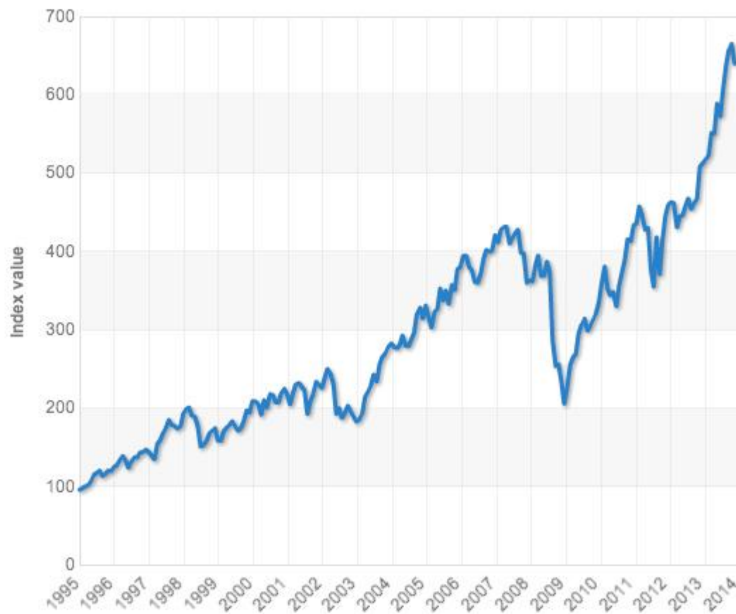
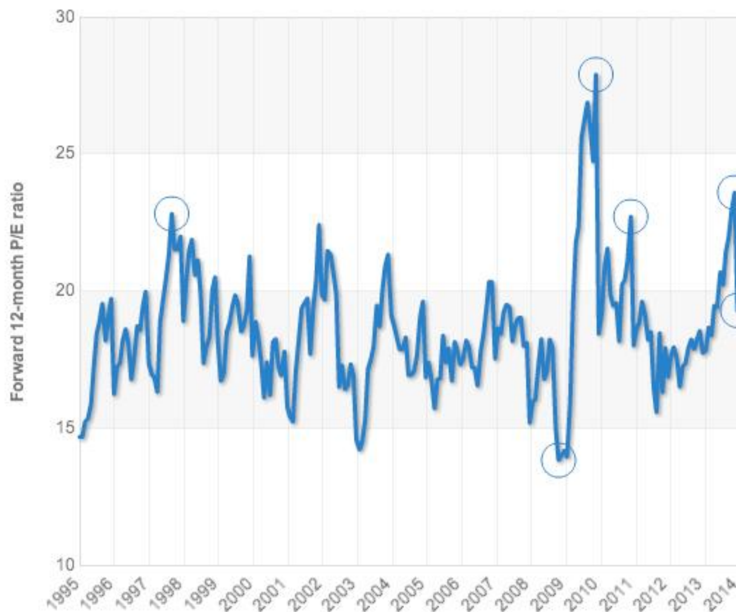
The Fed's policy-making board will now have to adjust its guidance, and possibly confuse markets, even though it is trying to be transparent about its policy and intentions. Janet Yellen assumed the chairmanship of the Fed in early February 2014, and she will be responsible for directing policy given this twist in the labor market. This brings us to our second collision.

The stock market valuation collision

Certain Fed officials (including Jeremy Stein, Elizabeth Duke, and Jerome Powell) have been uncomfortable with the open-ended nature of QE operations. They have called for a clear exit plan in early 2013, expressing their concerns about financial conditions and the propensity to create new bubbles in financial or property markets. The Fed, after back-tracking in September, has finally started to taper purchases of U.S. Treasury and agency mortgage-backed securities (MBS). Fed officials have stated that future tapering actions will be data dependent, a point they have repeatedly stressed. They have also been careful to point out that the fed funds rate will remain low for an extended period in order to gain confidence that they have achieved their economic improvement targets (see prior discussion on employment). Fed officials are trying to push market participants to concentrate on so-called forward guidance and want them to feel confident that the tapering actions will not upset financial markets. This guidance from the Fed, and the continued QE purchases, have had a marked effect on stock market valuations. I would argue that equity market valuations are significantly elevated. Jim Bianco, president of Bianco Research, gives us two charts that highlight valuations in today's markets:

Chart 3 shows growth in the S&P Small Cap 600 Index. The chart also illustrates that forward-looking ratios recently hit levels that were higher than at any time except at the onset of the global financial crisis (at which time forward earnings collapsed).





Data: Bianco Research LLC; Standard & Poor's

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The price-to-earnings ratio, or P/E ratio, is a valuation ratio of a company's current share price compared to its earnings.

The **S&P SmallCap 600 Index** measures the performance of 600 mostly small-cap stocks weighted by market value, covering approximately 3% of the U.S. stock market.

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Chart 4 has been a favorite of mine for some time. It measures the market capitalization of the **Russell 3000E™ Index** and compares it with nominal gross domestic product (GDP) in the United States. As shown, weak corporate performance, coupled with a healthy dose of Fed liquidity, has pushed stock market valuations back up to 120% of nominal GDP. Bianco's chart reveals that in the new era of outsized Fed influence, equity markets (1995 and beyond) have moved to an outsized capitalization level. The current reading is below the late 1990's technology bubble (and just below the level achieved before the global financial crisis), but it remains elevated in absolute terms. The

Fed, which is concerned about financial conditions and the risks of future bubbles, must be mindful of these readings. Fed officials are likely to push for continued tapering actions until they see normalcy return to these markets.

Data: Bianco Research LLC.

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Gross domestic product (GDP) is the measure of all goods and services a country produces.

The Russell 3000E™ Index measures the performance of the largest 4,000 U.S. companies (measured by market capitalization).

Central bank liquidity versus macroprudential policy

We believe it's fair to say that the world is awash in unprecedented central bank liquidity. In our view, this environment is due, in part, to the failure of central banks around the world to govern national bank systems or assess leverage levels (particularly in developed economies).

As the world slowly delevers, central bank liquidity will likely remain at high levels. To balance that condition, policy makers are pursuing a so-called macroprudential policy that will attempt to counter the liquidity by restricting risky ventures by regulated entities (mainly commercial banks). These policies have included minimum capital levels for banks, restrictions on capital market activity (the Volcker Rule in the U.S., for instance), bonus rule adjustments for bank employees, and simple leverage tests.

In my observation of the implementation of these macroprudential policies, I have seen pushback that has disturbed me. Particularly concerning is the pushback on simple leverage tests by both European and U.S. banks. These simple leverage tests get around the games that can be played with risk-based capital tests, and truly provide a check on leverage in the system. The simple leverage test restricts the ability of banking institutions to grow swiftly, which they see as a threat to the valuation rewards that equity markets can provide. There has also been pushback on activities related to the Volcker Rule. Once again, banks see this as a threat to their earnings capacity.

These rules need to have teeth in order to counter the massive liquidity. It will be hard to control commercial and investment bank activities in a world with such advantageous funding levels. It will also be the case that shadow banking activities will flourish without the checks that are slated to take effect. China, for instance, has been notoriously lax in checking its shadow banking activity after the global financial crisis, and it now has significant leverage issues in its financial system.

In an investment landscape saddled by the collision course described previously, we see a need for flexibility when managing fixed income portfolios in 2014. We are not sold on analyst predictions for higher rates and robust equity market gains. In fact, current equity valuations may be a limiting factor on those gains. Such valuations may also be a limiting factor on interest rate levels. We ask investors to be careful with bond fund investments that have delivered attractive near-term returns through investments in equity or equity-like securities. They may not be the diversifiers that investors can count on in bond-type investments.

When managing the portfolios we are responsible for, we will aim to move through this changing environment with an eye on proper diversification and prudent exposure to equity markets. Interest rate sensitivity will likely be dampened, but we will keep a keen eye on economic trends and the technical levels of interest-rate hedging in the marketplace.

The views expressed represent the investment manager's assessment of the market environment as of February 2014, and should not be considered a recommendation to buy, hold, or sell any security, and should not be relied on as research or investment advice. Views are subject to change without notice and may not reflect the investment manager's current views.

Carefully consider the Funds' investment objectives, risk factors, charges, and expenses before investing. This and other information can be found in the Funds' prospectuses and their summary prospectuses, which may be obtained by visiting our fund literature page or calling 800 362-7500. Investors should read the prospectuses and the summary prospectuses carefully before investing.

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Investing involves risk, including the possible loss of principal.

Diversification may not protect against market risk.

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Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility and lower trading volume.

International fixed income investments are subject to currency risk. Adverse changes in foreign currency exchange rates may reduce or eliminate any gains provided by investments that are denominated in foreign currencies and may increase losses.

If and when a portfolio invests in forward foreign currency contracts or uses other investments to hedge against currency risks, the portfolio will be subject to special risks, including counterparty risk.

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