What Investments May Taper Well?

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# The Tapering of Quantitative Easing: What It Will Mean

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## Introduction

When it comes to investing, there are few sure bets. But there is one sure bet: The Fed will reduce it monthly purchases of securities and US interest rates will rise. The question then becomes what this means for investors. I addressed this in my last article on the subject, but since then, The McKinsey Global Institute has published an excellent report on the subject in which they attempted to quantify many of the effects. This article summarizes the McKinsey findings and goes on to spell out the investment implications.

## Bank Actions

Table 1 provides data on central bank asset growth since 2007 calculated as a percent of 2008 GDP. Compounded GDP growth rates for the "recovery period" (2010-13) are presented in the right hand column. Countries that used QE did better than those (Eurozone countries) that did not. Japan also used fiscal (large government deficits). The US Congress allowed only one major stimulus package to be enacted. Had Congress allowed more deficit financing, it is quite likely that Bernanke would have used less QE.

**Table 1. - Central Bank QE and GDP Growth**

| Country/ Region | Balance Sheet Growth % 2008 GDP | GDP Growth Compounded 2010-13 |
|---|---|---|
| Japan | 20.6% | 2.0% |
| United Kingdom | 18.7% | 1.1% |
| United States | 18.2% | 2.2% |
| Euro Region | 6.6% | 0.6% |

**Source:** McKinsey Global Institute, IMF Data

Table 1. - Central Bank QE and GDP Growth
Source: McKinsey Global Institute, IMF Data

As a result of the QE actions, "policy" interest rates have been 1% or lower since 2009 in Japan, the UK, the US, and the Euro Region since 2009. The following section trace through the various economic impacts of these lower rates.
The Distributional Effects

The McKinsey study estimated the effects of lower interest rates on different economic "sectors" in the UK, the US, and the Euro Region (Table 2). Overall, borrowers benefited while lenders were hurt.

**Table 2. - Interest Rate Effects - Cumulative, 2007-2012**

| Item | US | UK | Eurozone |
|---|---|---|---|
| Central Government | 900 | 120 | 360 |
| Non-Financial Corps. | 310 | 120 | 280 |
| Banks | 150 | -40 | -230 |
| Insurance/Pensions | -270 | -60 | -130 |
| Households | -360 | -110 | -160 |
| Rest of World | -480 | -80 | -150 |

**Source:** McKinsey Global Institute

Table 2. - Interest Rate Effects - Cumulative, 2007-2012
Source: McKinsey Global Institute

Debt interest charge savings for central governments has been substantial. McKinsey estimates that in the US interest payments as a percent of debt fell from 4.8% in 2007 to 2.4% in 2101; for the UK and the Euro Region, the reductions were from 5.1% to 3.2% and from 4.5% to 3.3%, respectively. Of course, non-financial corporations also benefited from lower interest rates. Banks are both lenders and borrowers. In the US, banks have been able to take advantage of low interest rates when borrowing while at the same time keeping their lending margins nearly the same.

Insurance companies and pensions are in a tricky position. On the one hand, their balance sheets look better because the value of their bond and other debt holdings has increased. However, many of these institutions have issued annuities or their equivalents with guaranteed returns. And McKinsey notes that

in Germany, the average guaranteed return on life insurance policies is 3.19% while German government bond yields are only 1.75%. Adjustments are needed.

Household have also been hurt by the loss of interest income, but losses depend on whether you are net lenders or borrowers. Younger people are mostly borrowers while older people are mostly lenders. McKinsey estimated the differences by age bracket (Table 3). People under 35 saved $1,500 over what they would have paid without QE; people 75 and up lost 6% of the 2007 income because of lower lending costs (mostly returns on government debt).

**Table 3. - QE Impact on US Households by Age Bracket**

| Age | $ Saved | % Income |
|---|---|---|
| < 35 | 1,500 | 2.8% |
| 35-44 | 1,700 | 2.0% |
| 45-54 | 500 | 0.5% |
| 55-64 | -900 | -0.8% |
| 64-74 | -1,900 | -2.0% |
| ≥75 | -2,700 | -6.0% |

**Source:** McKinsey Global Institute

Table 3. - QE Impact on US Households by Age Bracket
Source: McKinsey Global Institute

## Global Effects

McKinsey concludes that QE caused a surge in portfolio bond flows to emerging markets. This is not apparent in US Treasury data (Table 4).

**Table 4. - Change in US Holding of Foreign Securities (bil. US$)**

| Item | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| Total | 1,545 | -3,278 | 2,018 | 909 | 340 | 1,387 |
| - Equities | 1,240 | -2,854 | 1,580 | 773 | 118 | 1,096 |
| - Debt | 305 | -424 | 438 | 136 | 222 | 291 |

**Source:** US Treasury

Table 4. - Change in US Holding of Foreign Securities (bil. US$)
Source: US Treasury

Investment Implications of QE Tapering

a. All indications are that the US economy is now on a sustainable economic growth path and the Fed will not taper unless it is convinced this momentum will continue.

Evidence on this comes from John Reese of Validea. Reese is one of the best writers on the US economy. In addition, his "Hot List" of stock pics is up 263% since 2003 inception as compared to the S&P 500 (up 81%).

His main points from last week's article:

"News on the jobs front has been quite positive. Private payroll processor ADP said the private sector added 215,000 jobs in November, the highest tally in a year. It also revised its October jobs-added figure to 184,000, up sharply from an original estimate of 130,000.

New claims for unemployment fell in each of the past two weeks. They now stand a whopping 37.2% below where they were a year ago.

The Institute for Supply Management. ISM said manufacturing activity increased in November for the 6th straight month, and did so at the fastest pace in two years.

ISM also said the service sector expanded in November for the 47th straight month, though at a slightly slower pace than it did in October.

The housing market also provided solid data. After declining 6.6% in September (which put them 10% below year ago levels) new-home sales jumped 25.4% in October. That put them more than 20% ahead of their year ago level. Permit issuance for new home construction rose 6.2% in October. That put them 16% above where they stood a year ago.

Gross domestic product grew at a 3.6% pace in the quarter, up from initial estimates of 2.8%.

Third-quarter earnings also ended up pretty solid. With all but seven of the S&P 500 companies having reported, about 66% had beaten expectations, a figure in line with what we've seen throughout the recovery."

b. Higher interest rates will mean higher borrowing costs. While this is true, it should also be kept in mind that people and firms have not been borrowing much even with low rates. This is in part because banks have tightened their lending standards. Consequently, it is not likely that higher borrowing costs will have much of an impact on borrowing.

c. As interest rates rise, debt prices and the prices of other high yield prices will fall. Higher Treasury rates will draw a lot of investments away from "high yield" investments that have been serving as Treasury substitutes. Take a look at Table 5. To substitute for Treasuries, some have purchased: Vanguard Total Bond

Market (BND), iShares JPMorgan USD Emerg Markets Bond (EMB), iShares U.S. Real Estate ETF (IYR), Fidelity Real Estate Income (FRIFX), WisdomTree Emerging Markets Local Debt (ELD), TCW Emerging Markets Income I (TGEIX).

If you are happy with your returns on such investments, fine. But if you are looking for capital appreciation, gains or losses, you should get out now. The prices of what have been Treasury substitutes will fall as Treasury rates increase.

**Table 5. - Performance of High Yield Investments**

| | % Change | | |
|---|---|---|---|
| Item | 5/21-6/24 | 6/24-12/10 | Yields |
| S&P 500 (^GSPC) | -5.8% | 14.67% | |
| Vanguard Total Bond Market (BND) | -3.9% | 0.74% | 2.47% |
| iShares JPMorgan USD Emerg Markets Bond (EMB) | -13.0% | 4.71% | 4.72% |
| iShares U.S. Real Estate ETF (IYR) | -15.3% | -0.22% | 4.10% |
| Fidelity Real Estate Income (FRIFX) | -7.5% | -0.96% | 4.82% |
| WisdomTree Emerging Markets Local Debt (ELD) | -11.4% | -0.73% | 4.18% |
| TCW Emerging Markets Income I (TGEIX) | -10.3% | 0.00% | 5.80% |

**Source:** Yahoo Finance

Table 5. - Performance of High Yield Investments
Source: Yahoo Finance

Bernanke made his ill-advised suggestion of tapering back in June. The right hand numerical column in Table 5 shows what happened to the S&P 500 and various Treasury substitutes' right after that statement. And while the S&P has recovered since then, the Treasury substitutes have not.

d. Higher US interest rates will draw a lot of assets from overseas meaning that foreign debt prices will fall and the US dollar will strengthen against foreign currencies. Foreign countries have hated QE because it makes their currencies stronger vis-à-vis the US dollar. This is bad for their export competitiveness. They will say hooray to a QE tapering.

e. A stronger dollar will cause overseas investments to lose value relative to US investments.

Again, they are Treasury substitutes. As Treasury yields become more attractive....So is this the time to invest in the US? Consider first what has happened to stock and bond prices since 2007 (Table 6).

**Table 6. - Changes in Bond and Stock Prices Since 2007**

| Item | US | UK | Eurozone |
|---|---|---|---|
| Bond Prices | 37% | 16% | 29% |
| Stock Prices | 27% | 4% | -9% |

**Sources:** McKinsey Global Institute and Yahoo Finance

Table 6. - Changes in Bond and Stock Prices Since 2007
Sources: McKinsey Global Institute and Yahoo Finance

US stock prices have grown rapidly since 2007. Are they near peaking? A commonly-used yardstick to address this question is the price to earnings ratio. Neither Reese nor McKinsey are concerned about its current level.

Reese: "The S&P 500's price/earnings ratio based on trailing 12-month operating earnings is 17.6; its forward P/E (using projected operating earnings) is 15.4. Those figures have been climbing, yes, but neither is indicative of major overvaluation. In fact, According to Charles Schwab's Liz Ann Sonders, those are both still shy of the 18.7 and 18.1 averages, respectively, for the past ten bull market peaks."

McKinsey questions whether equities and Treasuries are in fact substitutes. It doubts whether higher rates will serve as a real drag on stock market prices.

I offer the following. P/E ratios are quite different, depending on the years you choose to average (Table 7). In more recent years, P/Es have been higher. Why might this be?

**Table 7. - Price/Earnings Averages, Select Years**

| Period | P/E Ratio |
|---|---|
| 1985-2007 | 15.3 |
| 1995-2007 | 17.0 |

**Source:** McKinsey Global Institute

Table 7. - Price/Earnings Averages, Select Years
Source: McKinsey Global Institute

Foreigners have started to buy large amounts of US equities. In 2003, foreigners

owned only $1.6 trillion in US equities. That number had increased to $4.2 trillion by 2012. Together, the total capitalization of NASDAQ and the New York Stock Exchange in 2012 was $18.7 trillion. That mean in 2012, foreigners owned 22% of US equities. My sense is that at least for the foreseeable future, foreigners will continue to buy US equities. Where else do will they get such growth with safety?

In sum, US equity investments make a lot of sense.