CLEAR HARBOR
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Clear Harbor Flash – Lame-Duck Poker: The Post-Bernanke Future of the "Bernanke Put"

Long, long ago—that is to say, back in the spring—investors could safely assume a "steady as she goes" approach to U.S. monetary policy. Federal Reserve Chairman Ben Bernanke was happily presiding over his unprecedented scheme of expansionary actions; if he were to decide against another term for himself beginning in 2014, his lieutenant Janet Yellen could be expected to take his seat and play an equally dovish hand.

From a political perspective, muted inflation and employment growth seemed to justify the Fed's course, particularly in the absence of fiscal stimulus from Congress. Financial markets continued their climb. The game continued.

In June, two things changed the game. First, Mr. Bernanke said that quantitative easing (QE) could begin to taper off this year, and end altogether as early as the middle of next year if growth increased. Treasury yields and mortgage rates quickly spiked; capital flows shifted from the bond market to cash and even the equity markets.

As we have observed, this was hardly the end of the "Bernanke put." Indeed, Mr. Bernanke himself sought every opportunity to insist that any move off the gas pedal would have to be justified by consistently firmer economic data. But the card had been played, and it took markets off guard in light of persistent high employment. Yields, though still low by historic measures, remain near their June highs. Markets continue to price in some form of tapering after the Fed's next meeting in September.

That led President Obama to play his own card: he pre-empted Uncle Ben's announcement about his own future, saying publicly that the Chairman had been in the role "longer than he wanted or he was supposed to." Even as he complimented Bernanke on his stewardship during the financial crisis, he stirred the pot further by naming alternatives to Ms. Yellen, including former Harvard President and Treasury Secretary Lawrence Summers, the acerbic policy genius and Obama loyalist.

The President could still name Ms. Yellen to the top spot in January, which would itself be an historic moment for an institution that has never had a woman chief. But he has unmistakably emphasized the "lame duck" nature of the balance of Mr. Bernanke's term. And he has introduced the possibility that he will seek a new Fed chief who, far from scaling back recent easing measures, may be willing to push them even further to accelerate employment growth.

In short: the Federal Reserve is in the midst of a historic transition from both a policy and leadership perspective. All of a sudden, the sleepy parlor game of who is likeliest to succeed Bernanke has become a hand of poker carrying real consequences for the world economy.

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We at Clear Harbor have no direct line to Mr. Obama's thinking—or to Mr. Summers's, or Ms. Yellen's for that matter. But we now must consider strong odds of a Summers chairmanship, and what it could bring. It might spell the end of QE and a reversion to more conventional easing policies focused on a low Fed funds rate. Or it could mean even more dramatic policy actions than anything we have seen so far.

Make no mistake: QE has been effective. Confidence, consumption, credit and economic growth have reaccelerated from the nadir of the financial recession, providing significant tailwinds for corporate profits and the equity markets. Unemployment claims, non-manufacturing PMI and the trade deficit all continue, on balance, to improve. At least in part, this is the result of the purchase of $2.9 trillion in treasuries and mortgage backed securities since November 2008—a buying spree that has quadrupled the Fed's balance sheet, and which continues at the rate of $85 billion in government debt each month.

But questions remain. To what extent is demand being artificially supported by extraordinary Fed easing? Despite some stabilization, how and when will we see sustainable improvements in factory orders, construction spending, total unemployment, wages, and overall economic growth? And what, exactly, should we expect from QE at this point in the economic cycle?

For his part, Mr. Summers has voiced skepticism over the potential of QE to engineer further progress, telling an audience in April, "QE in my view is less efficacious for the real economy than most people suppose." This is a welcome view to those concerned with the sheer size of the Fed's balance sheet and its long duration—more than six years. This long duration would seem to limit the "dry powder" available should future intervention be demanded, particularly in a rising-rate environment.

Indeed, 10-year rates have risen by a full percentage point in just the past three months. While this normalization of rates offers investors a welcome real return for the first time in recent memory, such a sharp rise is likely to make the Fed as a whole wary of further abrupt rate increases, no matter who is at the helm. And that augurs for staying the current course, keeping

QE asset purchases up in an attempt to keep rates down, notwithstanding any reservations from Mr. Summers or other market observers.

- Beyond the Bernanke Put: "Overt Monetary Financing" Enters the Conversation

It is also possible that Mr. Summers could embrace a different sort of QE: one whose purpose is not to keep bond yields low, but to rekindle inflation and animal spirits by enabling higher spending by the central government. Dubbed "overt monetary financing" by Lord Adair Turner, former Chairman of the UK's Financial Services Authority, such an approach would tap the central bank's ability to print money with the explicit goal of financing deficit spending to stimulate the economy.

The chatter I am hearing about prospects for overt monetary financing in the U.S. is speculative, but it does fit the narrative of an administration that has long been impatient with Congress's reluctance to sustain high deficits. By linking monetary and fiscal policy, it could prove appealing to a president clearly uncomfortable that most of the benefits of QE are perceived as accruing primarily to companies and those who participate in financial markets, rather than those further down the economic ladder.

Should the current disgust with politics translate into a shift in the House of Representatives in 2014, a Fed chair with a proud track record of "creative" monetary solutions would be aligned with any number of equally creative fiscal policies Capitol Hill might generate. These could range from a repeat of the $300 Bush-era "rebate" checks mailed to taxpayers in 2001 and 2008, to funding an infrastructure bank, to traditional stimulus measures such as the unemployment compensation and direct aid to states that were adopted in the American Recovery and Reinvestment Act of 2009.

The President has yet to articulate any such vision of coordinating fiscal and monetary policy, much less demonstrate political progress toward what would undoubtedly prove a highly controversial goal. Yet it would flatter his long-stated ambition to spark employment and consumption among lower- and middle-class constituents. It would marry well with his recent emphasis on the Fed's employment mandate, as opposed to its traditional focus on price stability. And in Larry Summers, who counts the bailout of Mexico in 1994 and his management of the East Asian currency crises of the later 1990s among his signature moments, the President would find a partner with a long track record of undertaking bold moves to transform whole economies on the global monetary stage.

- QE Amid Declining Deficits

In the near term—say, through year-end—the Fed doesn't need a novel policy theory such as overt monetary financing to rationalize QE on its current course. Unemployment is at 7.6%, nowhere near the Fed's target of 6.5%; inflation remains well below the target of 2.5%; they may simply want to reserve any decision to change QE for the incoming chair, whoever that

might be. But one reality clearly augurs for tapering this fall: the federal deficit is falling, limiting the amount of net Treasury issuance that has been the primary focus of the program since its inception.

Even the most complex program is subject to the simple law of supply and demand. If the supply of Treasuries declines, the Fed must reduce its net purchases proportionally in order to have the same impact on the market. More than any other consideration, this is the reason we maintain a base case for some level of tapering in the last four months of the year, even though economic conditions appear less than robust and the next head of the world's most important central bank remains very much unknown.

- Alternatives to “QE Infinity”

In time, we are hopeful the Fed will recognize the dangers of the more exotic uses of QE, and their potential to undermine confidence in the central bank. This is particularly true in light of the more traditional alternative being pushed by incoming Bank of England Governor Mark Carney, who has outlined a path toward less QE coupled with an historically low funds rate for the indefinite future.

Carney has conveyed to markets that he is likely to withdraw quantitative easing, while remaining committed to the near-zero bound on the U.K.’s benchmark rate until unemployment has fallen from 7.8% to 7%. While this shift might be attributed in part to Carney’s desire to put his own stamp on policy, it seems a particularly sensible response to the first signs of something the U.S. has, for now, avoided: rising inflation. It is a playbook any future Fed chief should keep close by for the inevitable moment when the inflationary pressures they have worked so hard to achieve do in fact surface.

- Portfolio Considerations

On a global basis, we see a divergence among monetary authorities in terms of both their objectives and their relative room for maneuver. The U.S. and U.K. appear positioned to gradually step back from their QE programs, while maintaining a conventional “zero bound” on funds rates; the Eurozone and Japan appear committed to both types of easing for a protracted period, with deflation the most prominent threat. This contrasts significantly with most emerging market economies, where inflation has not declined at the same pace as growth and policymakers are more constrained in their options.

In fact, we expect inflation to remain low in the developed world and stubbornly high in the emerging world for the rest of the year. This informs our view to remain overweight the developed world over the emerging markets in the near term, while providing for select allocations that offer idiosyncratic risks and add value to individual portfolio strategies.

Back in the U.S., whatever the outcome of the Fed succession parlor game, our base case remains one in which some degree of QE tapering is announced before year-end. We have prepared our longer-term structural asset allocation for the potential of such a transition in Fed policy by keeping the duration in our fixed income portfolio below our benchmark, maintaining a higher-than-average cash position, and remaining overweight equities.

None of these moves prevent us from reconsidering bond exposures should monetary policy take a more exotic turn. But we think now is not the time to increase beta exposure, as the risks of a policy error are rising. We also note that approximately 75% of the move higher in the S&P 500 is due to expanding price-to-earnings ratios—not higher earnings. Analysts continue to forecast 9% growth for year, despite a mere 5% year-over-year pace over the last two quarters—a prescription for disappointment as year-end approaches. Even those who remain overweight equities must be careful just which equities they choose in such an environment.

Whether the President's ultimate choice to lead the Fed is Yellen, Summers, or someone less well known (such as Donald Kohn or Roger Ferguson), investors can no longer take the status quo for granted. Even in these slow summer months, Clear Harbor will keep an eye on the succession game, recognizing the wild cards lurking in it for portfolio strategies and economies around the world.