

Economic Stimulus Programs and the Implications for the Economy and Markets



Over the past several months an array of initiatives has been announced designed to arrest the downward economic spiral. Due to the evolving nature of the situation, some of the programs themselves have evolved since first introduced. In an effort to provide some clarity to the various initiatives, in the space below we will describe the major programs announced by policymakers, and will discuss the potential short- and longer-term economic and financial market implications. Finally, we will introduce a dynamic asset allocation approach to exploiting some of the opportunities presented as a result of the economic climate and the aggressive efforts to mitigate further damage.

Primer on Various Economic Stimulus Initiatives

Public-Private Investment Program

On March 23rd, Treasury Secretary Geithner announced the details of his plan to deal with the bad loans on bank balance sheets. The Public-Private Investment Program (“PPIP”) is a component of the broader Financial Stability Plan announced by Geithner on February 10th, which was poorly received by the markets because of its lack of details. By contrast, the PPIP was met with favorable market reaction.

The key element of the PPIP is the partnering of public and private sector funding. Whereas the original TARP plan contemplated such an arrangement, that plan was more heavily weighted toward public sector funding, and there was a fear politically that the government would overpay for the assets. The PPIP requires the private sector to put more “skin in the game,” in the hope of arriving at fair prices for the securities being purchased from banks.

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The PPIP consists of two primary components: 1) a Legacy Loans Program, which is designed to combine FDIC backing with private sector and Treasury equity capital to purchase troubled loans from banks and other insured institutions, and 2) a Legacy Securities Program, which combines financing provided by the Fed through the Term Asset-

Backed Securities Loan Facility (“TALF”) with equity capital from the private sector and Treasury to purchase troubled securities.

The Legacy Loans Program is designed to work as follows. A bank will identify a loan or pool of loans it wishes to sell, and let’s assume the face value of the pool of loans is \$100. The FDIC will accept bids on the pool, and let’s say the highest bid is \$70. Since the FDIC will guarantee the purchases at a 6-to-1 debt-to-equity ratio, equity capital of \$10 would be required (\$10 equity + \$60 guarantee = \$70). The equity capital requirement would be split equally, with the private sector and the Treasury each contributing \$5. If the pool is eventually sold at \$76, the profit of \$6 is also split equally, meaning the private sector investors made \$3 on a \$5 investment, or 60%.

The Legacy Securities Program is designed to work in a similar manner. The Treasury will select approximately five investment managers (likely to include firms such as PIMCO and BlackRock) to raise equity capital and select and manage pools of legacy securities such as non-agency mortgage-backed securities and other asset-backed securities originally rated AAA. Each \$100 of equity capital raised by the investment manager will be matched by the Treasury, which will also provide a loan for an additional \$100 (the loan could be \$200 if certain conditions are met).

The PPIP will initially provide financing for up to \$1 trillion of purchase of loans and securities. Many participants and analysts believe the Treasury will agree to increase this amount over time.

Stimulus Package (“Recovery and Reinvestment Act of 2009”)

The stimulus package agreed to by both houses of Congress and signed into law by President Obama on February 17th provides for \$789 billion in a combination of tax cuts, expansion of unemployment benefits and other social welfare programs, and spending in education, health care, and infrastructure. The Act allocates 37% of the funds to tax cuts, 18% to state aid (most of which will go to Medicare and education), and 45% to federal spending initiatives such as infrastructure.



Troubled Asset Relief Program (“TARP”)

The Troubled Asset Relief Program (“TARP”), first introduced by former U.S. Treasury Secretary Henry Paulson in the fall of 2008, is a program of the U.S. government to purchase assets and equity from financial institutions in order to strengthen those entities’ balance sheets.

TARP authorizes the Treasury to purchase up to \$700 billion of “troubled” assets, which include mortgage-backed and other securities or loans the Treasury deems important to stability in the financial system. These so-called “toxic” assets are generally illiquid and difficult to value, and are forcing banks that hold them to rein in lending in order to maintain adequate capital. The TARP program is designed to improve the liquidity of these assets, allowing financial institutions to remove them from their balance sheets, thereby enhancing the institutions’ financial position. The idea is that the improved financial standing will allow banks to lend more freely, unthawing the flow of credit.

TARP has gone through a couple of modifications since first introduced. The program was initially designed to have the Treasury use the entire amount to purchase toxic assets from financial institutions. However, Treasury Secretary Paulson changed course after a meeting with U.K. Prime Minister Brown, who had begun to oversee a program whereby the U.K. government injected capital directly into British banks, effectively nationalizing them. Paulson believed a more limited version of such an approach may also work well in the U.S. since there was a concern that banks may not be willing to sell the toxic assets at the prices the Treasury or its agents were willing to pay. The Treasury then called the heads of the country’s major financial institutions to Washington to inform them they had no choice but to accept the Treasury’s capital. They consented, many reluctantly, and some are now making concerted efforts to repay the TARP funding so as to get out from under the accompanying restrictions, such as limits on executive compensation.

While initially meant specifically for financial institutions, TARP money has also been used to provide loans to GM and Chrysler to enable them to avoid bankruptcy. In addition, up to \$100 billion of TARP money will be used to fund the Public-Private Investment Program described above.

Term Asset-Backed Securities Loan Facility (“TALF”)

The Term Asset-Backed Securities Loan Facility (“TALF”) is a program announced in November 2008 by the U.S. Federal Reserve that is now beginning to be rolled out. The program is primarily designed to support the issuance of asset-backed securities (“ABS”) collateralized by student loans, auto loans and credit card loans. Under TALF, the Fed will lend up to \$1 trillion (originally \$200 billion) to holders of certain AAA-rated ABS backed by newly and recently originated consumer and small business loans. TALF funds will also be used to provide financing for the recently announced PPIP.

The hope is that the purchases will flatten the yield curve, driving down Treasury yields to such an extent that credits and equities become more attractive in comparison.

In what respects do TARP and TALF differ? Aside from the obvious slight difference in the current size of the programs and the fact that TARP is Treasury-sponsored while TALF is a Fed program, TARP is essentially designed to aid financial institutions while TALF is primarily meant to assist the consumer.

Treasury Purchases by the Fed (“Quantitative Easing”)

On March 18th the Federal Reserve announced that it would be purchasing \$300 billion of Treasury securities over the next six months. Many economists believed the Fed would eventually undertake such action, but the timing seemed to surprise the market: on the day the program was announced Treasuries surged in price, generating the largest one-day drop in yields since the 1987 crash.

Treasury purchases by the Fed, often referred to as “quantitative easing,” essentially amount to a bare-knuckle means of injecting money directly into the system. Through such monetizing of the debt the Fed can ramp up liquidity quickly, but the process is often very inflationary. The Fed appears to still be more concerned about deflation, and is willing to bet that it can undo any future inflationary effects.

It seems the Fed’s goal in this process is not only to increase liquidity in the system, but to make Treasuries less attractive compared to riskier assets. The hope is that the purchases will flatten the yield curve, driving down Treasury yields to such an extent that credits and equities become more attractive in comparison. In addition, mortgage rates dropped on the news, achieving one of the Fed’s objectives, spurring a surge in re-financings and assisting homeowners having trouble making mortgage payments.

At the same time the Fed announced the Treasury purchases, it also stated that it would increase its previously announced purchases of agency mortgage-backed securities by \$750 billion, bringing its total purchases to \$1.25 trillion. The goal with this program is to provide further support to mortgage lending and housing markets.

Economic Impact of Stimulus Initiatives

In assessing the economic impact of these various aggressive initiatives, it is perhaps best to consider both short- and longer-term implications, as they will likely be very different.

In aggregate, policymakers seem to have learned from policy missteps and now appear to be trying to err on the aggressive side. Some economists have described the Fed and Treasury as being slow to recognize the seriousness of the economic problems early on, and until very recently, Fed Chairman Bernanke had been less visible than the situation warranted. And from the very outset of the Obama administration, Treasury Secretary Geithner has been excoriated by analysts for, among other things, offering few details in the initial roll-out of the bank bailout plan, a lack of leadership in the discussion about bank nationalization, and generally appearing to be in over his head.

In addition, the market has been unkind in its assessment of President Obama's proposed budget, in large part because the budget calls for more than \$600 billion in new taxes on the wealthiest taxpayers, as well as new dividend and capital gains taxes. Further complicating matters is that Obama would like to reduce the budget deficit by more than half near the end of his term, which would require some combination of additional taxes or drastic cuts in spending. Adding fuel to the fire was the anti-Wall Street furor over the bonuses paid to AIG executives.

But Bernanke and Geithner seem intent on righting the ship. In recent weeks, policy moves and communications seem to have

become better coordinated, and the major actors have exhibited a resolve to doing whatever is necessary to get the economy back on track. They realize that continued deflation in asset values will cause some otherwise solvent firms to become insolvent. According to economist David Hale, "Mr. Bernanke is taking unprecedented actions because he perceives that the economy faces unprecedented risks. It will be impossible for future economic historians to write articles comparing Fed policy during the current crisis to the mistakes made during the early 1930's. Mr. Bernanke is taking extreme risks on the



side of accommodation compared to a Federal Reserve which failed to provide adequate liquidity during the 1930's banking crisis, and then tripled interest rates to protect the dollar in 1931." For his part, Obama has tried to cool emotions and slow legislation designed to enact a confiscatory tax on the AIG bonuses.

While we are by no means out of the woods yet, and there is almost certainly further pain to be felt on the housing and banking fronts, the recession seems to be passing its point of maximum strength.

The short-term (i.e., less than one year) effects of these initiatives, once fully implemented, are likely to be positive, resulting at least in a curtailment of the downward deflationary spiral that we have witnessed since last autumn. In fact, while likely not a direct result of the fiscal and monetary programs, some recent economic reports have indicated that the trends are "less negative" than previously.

While we are by no means out of the woods yet, and there is almost certainly further pain to be felt on the housing and banking fronts, the recession seems to be passing its point of maximum strength. The worldwide stimulus programs will only serve to continue the improvement. While the flow of credit is still nowhere near as fluid as it is in a normal environment, the situation does not seem to be getting worse, and the Fed's quantitative easing should support a continued freeing up of credit. Given these circumstances, it is reasonable to expect continued economic

stabilization and improvement in 2009, and perhaps a full economic recovery in 2010.

Longer-term Implications

But how might the massive stimulus programs be expected to affect the economy longer-term? In order to reflate the economy and avoid continued debt deflation, are we mortgaging our economic future?

There are at least two lines of potential concern that will need to be addressed once the economy stabilizes: the potential inflationary impact of the Fed's monetization of debt, and the effects of the enormous amount of borrowing to fund the other programs.

To be sure, the sheer amounts of stimulus that will be coursing through the economy have the potential to not only rekindle growth, but to also spark inflation down the road. Because there is still an imminent danger of deflation, the Fed is right in its position that inflation does not pose a serious threat over the short-term. The Fed also believes it can be nimble enough to reverse course on its quantitative easing program by selling Treasuries (in order to remove money from the system) once GDP growth stabilizes.

Once the economy recovers it is certainly possible that we will experience a "double dip" recession. The Obama administration's dual objectives of increased spending on new and existing initiatives as well as budget deficit reduction by the end of his term can mean only one thing: higher taxes to come. Higher taxes—a notorious growth killer—coupled with higher interest rates designed to choke off inflation, could produce a second contraction. It is obvious that Obama, Congress and the Fed will each need to pay careful attention to what the markets are saying going forward.

Potential Implications for the Financial Markets

The stock market seems to approve of policymakers' newfound aggression in attacking the deflation problem. From its intraday low on March 6th to its intraday high on March 25th, the S&P 500 gained approximately 25%. Have we seen the lows in equity prices? It is difficult to say, but the market's recent performance in reaction to the more coordinated and credible communications coming out of Washington is a good sign. If nothing else, the recent initiatives being undertaken should tilt the balance in favor of investing in risk assets as opposed to Treasuries. Hence, while the ride will be bumpy, and by no means are we in the clear, from an overall asset allocation perspective, stocks are likely to outperform bonds over the next six to nine months.

Some of the risks to this view would include a reemergence of the downward economic spiral in spite of policymakers' efforts to reflate; a negative investor reaction to seemingly inevitable bank insolvencies and the attendant nationalizations; and renewed acceleration in downward pressure on housing prices.

We are not alone in this outlook. According to Bloomberg, JPMorgan Chase & Co. is predicting the S&P 500 will end the year at around 1,000, which would represent a further 22% gain from its current levels; Goldman Sachs places fair value on the S&P 500 at 1,025 in a year, a further advance of almost 26%; Barton Biggs, formerly with Morgan Stanley and now with hedge fund Traxis Partners, believes we are in the midst of a 30%-50% rally in stocks; and Mark Mobius of



Templeton Asset Management believes the next "bull market" rally has begun.

Among those in this camp is Nouriel Roubini of New York University, who recently told Bloomberg that he believes that stock prices will continue to fall through 2009 as the economy contracts.

Is this time different?

What about relative prospects of stocks and bonds over the longer term? Some are saying that the current environment is somehow different than previous recessions, and that somehow fundamental risk/return expectations no longer hold. Under this view, stocks will continue to underperform bonds for the foreseeable future.

However, stocks will always have higher expected returns than bonds because of their relative positions in the capital structure hierarchy: common stock holds a less senior position than debt, and is therefore riskier, meaning investors will demand higher

expected returns for holding stock. Obviously, in any given year—such as 2008—stocks can underperform bonds, but the equilibrium expected returns for stocks will always be higher. Otherwise, capitalism as we know it would no longer exist because everyone would want to loan money rather than invest equity.

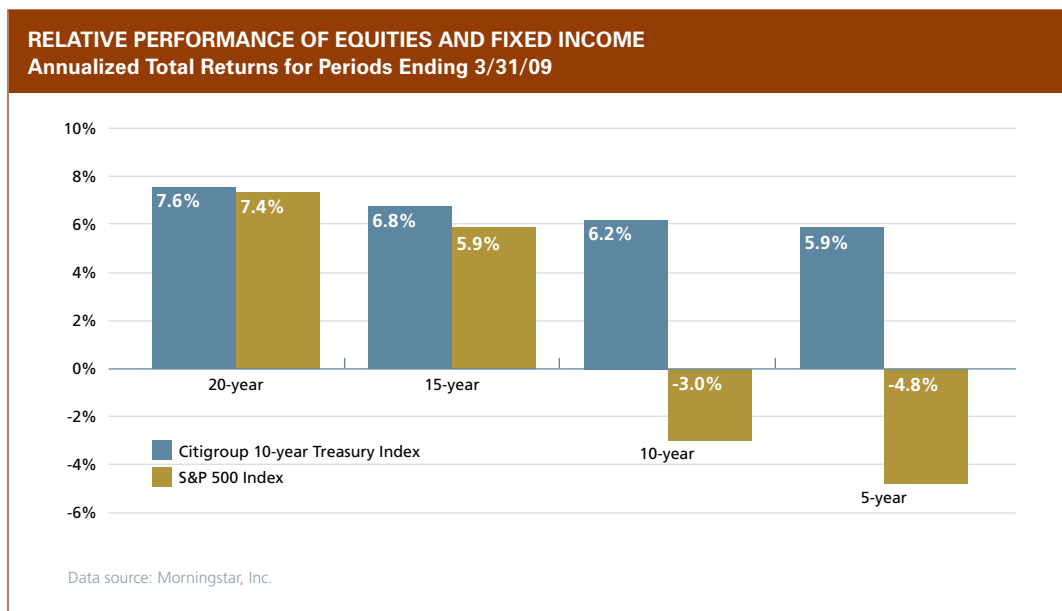
A solid case can also be made that on the basis of current relative valuations stocks represent an extremely compelling intermediate- to long-term opportunity compared to bonds, or any other asset class for that matter. According to BCA Research Inc.,

been rewarded with any higher returns than if they had invested in government bonds. This result is definitely abnormal. The only explanation possible is that when equity bubbles have been punctured, other kinds of distortions may have been created in financial markets. Simply put, stocks might have been driven down to a level where they are grossly undervalued relative to bonds.”

—BCA Research Inc.

*“Over the last 25 years, the total return for U.S. equities has actually been lower than those of U.S. 10-year government bonds. Over the last 10 years, U.S. stocks have delivered -47% in real returns, but bonds have produced a 71% gain in real terms. **These are stunning results: For a quarter of a century, investors who have taken on more risk to grow the economy have not***

It is truly remarkable to think that investors would have been better off over at least the last 20 years—the Golden Era for technology, productivity advancements and information processing—investing in government bonds rather than stocks. Not only does this fact seem to indicate that a reversion in relative performance is long overdue, one could easily see how stocks may be poised to perform more strongly than most analysts currently expect.



Taking Advantage of the Investment Opportunities

The dislocations that have occurred in the market over the past several months, coupled with the various remedial programs the Fed and Treasury have initiated, present opportunities for investors. Within a strategic asset allocation, investors may wish to dynamically tilt allocations somewhat to exploit these opportunities.

Below we have provided some dynamic views, or tilts, that we believe make sense

given the environment. In addition to the strategic asset class and the suggested tilt, the rationale for the view is given. These tilts can be employed irrespective of the investor’s risk profile, be it conservative or aggressive. We will update these dynamic tilts as warranted.

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ASSET CLASS	TILT	RATIONALE
EQUITY	Overweight US equity relative to International Developed Markets equity	US policymakers have been more aggressive at reflating, particularly recently. The ECB has been slower to react to conditions.
DOMESTIC EQUITY	Overweight Large Cap Relative to Small Cap	In the current credit constrained environment, companies in position to easily obtain credit should outperform. Typically, larger companies with strong balance sheets are in such a position.
INTERNATIONAL EQUITY	Overweight Emerging Markets	Emerging economies have not been affected by the recession to the same extent as developed economies. Emerging markets are likely to rebound more quickly.
	Overweight China	Many analysts believe China will be among the first countries to emerge from recession. Government policymakers were quick to implement fiscal stimulus.
FIXED INCOME	Overweight Credits Relative to Treasurys	Credit spreads remain high, and the Fed’s Treasury purchasing initiative should further increase the relative attractiveness of investment-grade corporate bonds.
ALTERNATIVES	Gain Exposure to Gold	The Fed’s aggressive monetization and a declining dollar are positives for gold.
	Gain Exposure to Currencies	The various stimulus initiatives, particularly the Fed’s quantitative easing, will be bearish for the dollar, at least in the short run. While the euro’s prospects aren’t much better than the dollar’s, the U.S. has been quicker to take aggressive stimulative action.

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