Following a strong first half of the year, the summer saw renewed volatility (both down and up) in stocks, and the bond market witnessed a precipitous slide. We wouldn’t go so far as to describe investors’ tempaments as anxious, but in listening to our clients we detect a latent uneasiness stemming from continued reports of the slow pace of economic recovery in the face of strong monetary stimulus. The prospect of “tapering”—the Federal Reserve’s dialing back its Quantitative Easing (QE) program of bond purchases—has clearly weighed on the bond markets. Equities too have been impacted, particularly in the emerging markets where capital flows both in and out can have a magnified effect.

The fragile nature of the U.S. economic recovery appears to call for the continuation of strong medicine in the form of accommodative monetary policy, particularly in light of the Fed’s recent decision not to begin tapering. The job market has been slow to rebound and unemployment remains stubbornly high. QE has been the principal policy response, yet the longer it stays in place, the greater will be the challenge of ultimately unwinding it without significant dislocations. Particularly in its more recent third stage (“QE3”), QE has created a mounting portfolio of Fed-owned securities that, one way or another, will ultimately need to be absorbed by the markets.

Thus, it might be fair to frame the issue something like this: When the Fed ultimately reduces QE, it will remove much-needed stimulus, yet the longer QE lasts the greater will be the challenge of unwinding it. In an effort to address this dilemma and its implications for investing, we will review the purpose of Quantitative Easing and the challenge it faces in bolstering the weak job market. We will then touch on the risks associated with unwinding QE at some point in the future. Finally, we will discuss how we are positioning portfolios to take these risks into account.

QE’S PURPOSE

In order to gain a better understanding of the situation, let’s look at the purpose of QE. Unlike conventional monetary policy, which attempts to manage the level of short-term interest rates in an effort to control inflation, QE is intended to directly increase the money supply and thereby stimulate lending, asset purchases and business activity. By purchasing securities of varying maturities, the central bank lowers interest rates across the maturity spectrum, a strategy that has greater potential economic impact than confining activities to the short end. While the removal of the Fed as a major source of demand for these securities at some point will have (indeed, has already had) the effect of raising interest rates generally, we believe that underlying economic activity should continue to improve for several reasons:
JOBS, TAPERING AND RISK  

• The Fed is on record as targeting 6.5% unemployment—significantly better than the current level. In other words, the central bank will continue to apply stimulus for an extended period to achieve the objective.

• The availability of low rates for such a long period of Fed easing allowed companies to undertake refinancing on a major scale, positioning them to spend more aggressively as conditions improve and confidence returns. Balance sheets are generally in great shape, and profit margins are near record levels.

• As contrasted with reducing stimulus, the Fed seems unlikely to deliberately tighten monetary policy in the foreseeable future. Generally, raising rates is a reaction to the prospect of rising inflation, but at this point inflation remains very much at bay.

• Monetary stimulus always operates with a lag. Thus, the aggressive easing program of recent years is likely to have an impact that lasts for some time.

As noted above, the Federal Reserve is committed to a goal of reducing the unemployment rate, currently 7.3%, to something below 6.5%. Needless to say, putting more Americans to work is politically important as well. Accordingly, we would expect some level of stimulus to remain in place until that goal is met or at least reasonably within reach. And for reasons set forth below, it’s likely to take time for unemployment to decline to that level.

In the current recovery, unemployment has proven to be stubbornly resistant to both fiscal and monetary stimulus. According to the Federal Reserve Bank of San Francisco, as of March 2013 the U.S. economy has recovered only two-thirds of the jobs lost during the downturn, while a similar 37 months into past recoveries employment has typically far exceeded pre-recession peaks. From another perspective, the ratio of people seeking jobs to the number of jobs available is currently about 3:1, based on a report from the Economic Policy Institute. The report goes on to point out that during “normal” times, such as 1948-2007, the ratio never goes above this level and is typically below 2:1.

Lower participation in the labor force makes the employment numbers look better than they otherwise would. Participation is defined as the percentage of the civilian non-institutional population age 16 and older either working or looking for work. Starting around 58% following the end of World War II, the rate gradually increased, peaking in the late 1990s at 67%. Much of the gain over the decades was due to the entry of women into the labor force, along with demographic changes having to do with the aging of the baby boom generation. Since the turn of the century, however, the rate has rolled over and now stands at 63.2% based on Bureau of Labor Statistics (BLS) data—the lowest since 1978. While participation tends to rise slightly during economic expansions as marginal workers find job opportunities, in the current recovery it has declined, in effect making the unemployment rate look artificially low.

Another reason the unemployment figures may be somewhat misleading on the positive side is that recent improvements have been driven in large part by the growth in part-time jobs. In the first half of 2013, BLS household survey data recorded 557,000 new part-time jobs and just 130,000 new full-time jobs, yet part-time workers comprise only 19% of the workforce.

Several reasons are cited by economists for the slow recovery in jobs.

• “Jobs Gap”: The U.S. faces a significant challenge in returning to pre-recession employment levels because of the combination of job losses due to the downturn and the gradual population-driven increase in the number of labor force entrants each month. The sum of these two factors is called the “jobs gap,” and estimates by the Hamilton Project of the Brookings Institution indicate that it will take 208,000 new jobs per month to close the gap by 2020. To maintain such a pace (the strongest of any year since 2000) for six years in a row is a tall order.

• Income polarization: The widely discussed and growing disparity between high- and low-income earners represents another challenge in returning the nation to full employment. Much of the growth in jobs in recent months has been in low-paying sectors like retailing, leisure and hospitality, while higher-paying positions in manufacturing have hardly increased. An interesting

![Figure 1: Labor Force Participation Rates at 35-Year Low](image-url)
article in *The New York Times* titled “How Technology Wrecks the Middle Class” cited advancements in technology as another source of income polarization. Increasing computerization of tasks has created high-paying jobs among those with the skills to manage them but in many cases these tasks have replaced middle-skill manual jobs. Low-end tasks like cleaning hotel rooms can’t be computerized and thus are available, but there are plenty of people to fill them and so they remain low-pay.

- **“Skills gap”:** Much has been written about the failure of American educational institutions to keep up with the evolving skill requirements of many of today’s jobs. Not only does the skills gap result in certain kinds of jobs moving overseas, but it also causes a kind of “structural” unemployment problem in the U.S. In our conversations with clients and the management of many of the companies we cover, we find CEOs saying they simply cannot find qualified candidates for jobs they need to fill in order to meet their growth objectives.

- **Confidence:** The slow recovery has been something of a drag on confidence among both business owners and workers. Businesses often cite taxes and costs associated with the Affordable Care Act as a reason not to add employees, but we suspect that if demand were stronger those concerns would be less of a factor. The number of “discouraged workers” is up about 14% in the last year, according to BLS. These are people who are not counted in the labor force because they have given up looking for work in the belief that there are no jobs available to them, but they represent potential labor force entrants who could keep the unemployment rate from declining much if they decide to look for work again.

### SIGNS OF PROGRESS

Lest we sound too gloomy about the prospects for further employment gains, we should not lose sight of the progress made since the recovery began. After peaking at 10.0% in October 2009, unemployment has declined to 7.3% today. And just before QE3 was initiated in September of last year, it stood at 8.1%.

There are also some positive signs going forward. Most important is that the private sector has added jobs while governments have generally shrunk their work forces. Once the downsizing effect of federal “sequestration” has abated, probably next year, government cut-backs should be less of a drag on employment. Further, fewer workers are losing their jobs, as indicated by the Labor Department’s weekly data on initial jobless claims. In August, the four-week average of unemployment claims reached 330,000, a six-year low. Finally, a regular Conference Board survey shows the number of households indicating that jobs are hard to get is falling relative to the number who say jobs are plentiful. Capital Economics points out that this trend correlates tightly with a decline in unemployment, so we may see more improvements in coming months.

Still, progress is uneven. As a result, the Fed is on hold until it becomes clear that the employment picture is reaching its expressed objective. Chairman Bernanke is on record saying that the central bank will not sell mortgage-backed securities but instead let them mature, implying a slow run-off of that part of its portfolio. Assuming that tapering unfolds more or less as we believe (starting later this year or early next), the Fed’s balance sheet will peak at nearly $4 trillion sometime in 2014 and then start shrinking. It wouldn’t reach pre-QE3 levels of just over $2.5 trillion until 2016, and it will take years after that to get back to pre-financial crisis norms of about $500 billion.

Coupled with the admittedly reduced but still substantial need to finance ongoing fiscal deficits, the sheer magnitude of absorbing the Fed’s portfolio into the markets is formidable, even if the process were to take a decade. The fact that the entire national debt was about $6 trillion just 10 years ago helps put this in perspective. Attempting to look years into the future with a somewhat cloudy crystal ball, investors are beginning to ask such questions as:

- How high will interest rates eventually go?
- Will inflation accelerate to levels requiring the Fed to severely tighten the money supply, triggering another major recession and destroying confidence?

### FIGURE 2: The “Jobs Gap” Remains High

*Job-Seekers Ratio, December 2000-April 2013*

Note: Shaded area denotes recessions

JOBS, TAPERING AND RISK

IMPLICATIONS FOR PORTFOLIOS

We cannot know the answers to these and other similar questions with any degree of certainty since they won’t come into focus for several years, but we ask them of ourselves regularly and they must be factored into managing client portfolios. Rather than guessing at the unknowable, however, we think a reasonable approach is to address risk by assessing the degree of excess reflected in the markets today. If we conclude that confidence is not particularly high—and risk levels therefore not elevated—we can feel more comfortable that the markets are discounting some of the risk factors mentioned above. Going through this exercise convinces us that portfolios should be well diversified but remain invested with a focus on quality.

In considering the overall environment today, it would be hard to argue that equity investors are over-confident. Yes, the Standard & Poor’s 500 Index recently reached an all-time high, but corporate profits are nearly 30% above their pre-recession peak. Price/earnings valuations are within historical norms, as the stock market’s gains have been driven more by profits than valuations. Company balance sheets are in excellent shape, and corporate cash flow is strong. As we’ve pointed out before, the amount of money flowing into equity mutual funds has been a mere trickle, and in fact August saw sporadic outflows—a sign of investor caution in our view. Today’s environment is nothing like the levels that existed in, say, 2007 just before the financial crisis or in 1999 during the tech bubble.

Within equities, various segments of the market and investment styles offer different levels of risk, and it’s important to take them into account in allocating assets. As an example, we have recently been advising clients to increase their exposure to U.S. value stocks, in part because they are selling at lower price/earnings ratios (hence less valuation risk) than growth stocks, yet we believe that in many cases they offer meaningful opportunity for increasing their earnings and dividends. Our view of international equities is colored by the continued risk of sluggish demand and weak banking systems in the developed markets, where we maintain an “underweighted” position for most clients. Similarly, our U.S. small-cap portfolios have relatively little exposure to developed international markets. Emerging markets have suffered from weakness in local currencies brought about by the flow of capital into dollars as U.S. interest rates have moved up. As currencies stabilize, emerging markets equities should prove attractive. In all cases, we are taking pains to assess each individual company’s fundamental underpinnings and ability to deliver strong long-term results.

The credit markets find themselves in a somewhat different place. Excess liquidity created by the Fed’s long-running easy money policy has worked its way into the financial system and severely inflated asset values. Unlike equities, many segments of the bond market are just below record-high valuations. At a time when the yield on money market funds and short/intermediate Treasury securities has been negative in inflation-adjusted terms, investors have reached for yield, bidding up the prices of bonds that seemed to offer incremental returns. Puerto Rican municipalities are a good example. The summer’s sudden correction in the credit markets—most visibly the near doubling of yield on the 10-year Treasury bond to about 3%—finally took the steam out of the bond market, but we remain concerned that continued economic expansion could push rates higher over time. Further down the road, it’s hard to know the impact that unwinding QE will have on inflation. As a result, we continue to keep maturities relatively short and focus on quality. We’re also using hedged (i.e., long/short) fixed income vehicles and income-producing real estate partnerships for qualified clients in an effort to produce income and add diversification in the form of noncorrelated assets to portfolios.

The consequences (and risks) of “unwinding” won’t be fully understood for several years, although they deserve careful monitoring as tapering gets underway. In the meantime, securities valuations do not appear excessive, and profit opportunities remain. 

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