MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

Message from the Fed: Volatility Ahead

The financial markets sent a reminder to investors as the second quarter of 2013 came to an end: remain alert, as things can change quickly! On Tuesday, June 18, the S&P 500 index closed just 1% shy of its all-time high (set four weeks earlier). The following day, the Federal Open Market Committee of the Federal Reserve announced that it was raising its expectations for growth for next year, and provided detail on the likely timetable for phasing out ("tapering" is the popular current term) its bond-buying program. Stocks crumbled under the weight of panicky liquidation, falling 5.6% over the ensuing four days before stabilizing. Anticipating such a move by the Fed, bonds have fared even worse, with the yield on the 10-year US Treasury note rising from a low of around 1.63% on May 1 to 2.72% on July 5, pushing prices down by 10%. Interest-sensitive sectors of the equity market have mirrored the decline in the bond market, with real estate investment trusts, housing stocks, and utilities all posting double-digit declines in a matter of weeks. The S&P 500 index, after having been poised to add meaningfully to its first quarter gains, ended the second quarter just 2.4% higher than where it began.

Specifically, Chairman Ben Bernanke indicated that the Fed *could* start reducing its purchases around year-end, and end them altogether by mid-2014, *if* economic conditions warrant (emphasis added). But the Fed has made absolutely no new ironclad commitments, and in fact was at pains to emphasize that "less easing" should not be equated with "tightening". Despite this attempt at reassurance, no one should be surprised that a possible end to the longest and most aggressive period of easing by the world's most important central bank would lead to some financial market disruption. After a five-year period featuring 520 separate rate cuts and $12 trillion in asset purchases worldwide[1], investors have become trained to expect certain behaviors from their central bankers, and have built portfolios accordingly.

The market's skittishness isn't all that surprising but probably should be discounted to a degree. Much of the market decline so far has been a combination of panic selling coupled with forced liquidation of highly-leveraged positions –the market is not making a judgment that the corporate profits outlook is suddenly weaker. Ultimately, the Fed will take its cues from the economy, and substantially better performance will be needed for the Fed to end its aggressive stimulus program. But a stronger economy will benefit stocks directly in two ways. First, stock prices should follow a rise in expectations for corporate profits. And second, as rates rise and bond prices fall, investors could shift significant funds away from bonds and into equities. We discussed this "great rotation" scenario in our last issue of *Consilium*.

We agree with the Fed that, all else being equal, there should be fewer impediments to economic growth as we get through 2013, and that there is at least a fair chance of economic acceleration and faster earnings growth heading into next year. We also agree with the Fed's characterization of their announcement: this is not a step toward an actual tightening of monetary policy. Bernanke himself noted that "premature tightening would carry a substantial risk of slowing or ending the economic recovery". That said, we – and the Fed – will be monitoring conditions carefully in the weeks and months ahead. Housing activity and consumer spending in particular must remain relatively buoyant in the face of now-higher mortgage rates for the Fed's forecast to materialize. If they weaken, it will be *status quo ante* for the Fed and investors.

Sources: [1]*Bank for International Settlements*

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We conclude that a choppy, unsettled period for the stock market could be the immediate result of an end to the Fed's Quantitative Easing program – but corrections are normal and generally unavoidable. The much more serious question is when will the Fed become hostile to the markets by tightening policy and risking a recession and a bear market? Given the slack in the labor markets (25 million unemployed or underemployed), product markets (factory utilization just 77%), and meager inflation pressure (just 1.4% year-over-year), we attach very low odds to such a scenario for the next year or two, at least. Once investors realize that they have little to fear from a return to a "normal" economic and interest rate environment, stocks should be in position to perform well.

Sources: *Baseline*

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