Commentary
June 25, 2013

We have long espoused a belief in these notes that a significant factor causing the positive returns in financial markets since March 2009 is the huge liquidity injections made by the world's central banks. No longer can the point be argued, as the markets have become almost obsessed with the actions and utterances particularly of the U.S. Fed, the Bank of Japan and the Peoples Bank of China. Recently investors have not wanted economic news to be too strong for fear the monetary stimulus would be lessened or removed. Last week's subtle change of outlook at the Fed has made that possibility a reality.

Mr. Bernanke announced at his most recent press conference that the Fed bond buying program would be slowed ("tapered") over the next year, starting perhaps as early as September. This is the first sign that a new direction is in the offing. Global markets were off sharply on the news, despite the fact everyone was aware the punch bowl would have to be removed at some point. The Chairman argued that U.S. Economic Data was sufficiently buoyant to compensate for this reduction in monetary stimulus. He may be right, but though we remain believers the U.S. will continue to grow, from the point of view of many, recent economic reports have not been encouraging enough. Make no mistake, Fed policy is still accommodating. Even at a slower pace the math would suggest further liquidity injections of a half trillion dollars over the next 9 months to a year. In addition there are no plans to raise policy rates any time soon. Of course, Fed actions are always "data dependent" such that signs of economic weakness would prompt it to reopen the monetary spigots. Mr. Bernanke is a leading scholar of the "Great Depression" and it is not lost on him that the Central Bank tightened policy in the mid 1930's assuming the worst was over only to lead to another downturn in 1937. As has been suggested, the back-up plan may be QE4"Ever". The potential good outcomes for the markets are a reacceleration of GDP in the second half, or if not, renewed accommodation from the Fed. The one big concern is that investors, having been confronted with the possible end of stimulus, lose confidence in the Fed and the economy. As an aside, we see no major change in policy if Mr. Bernanke retires next year as expected.

The announcement of "tapering" combined with the increase in U.S. Treasury 10 year yields from 1.5% to 2.5% is having an impact globally as much as in the U.S. These factors are causing unwinding of the so called "carry trade". Easy money has been made by borrowing in low interest rate countries such as Japan and the U.S. and investing in higher rate countries like Turkey, Brazil and Vietnam. Obviously, investing in emerging and developing nations involves taking on risk. As long as the Central Bankers of the developed countries provided excess liquidity and rates remained low that risk was manageable. Now with the Fed's change in the tenor of policy those trades are being unwound, which puts great pressure on emerging markets and their currencies.

While the markets are focused on monetary policy, we should not ignore other issues that could have an impact. The impasse in Washington continues, as efforts toward meaningful legislation are hung up in Congress. Last week the Farm Bill went down to defeat, not just because Democrat's and Republican's couldn't agree, but at the last minute the more conservative Republican's deserted their own party leadership. This does not bode well for dealing effectively with more serious issues such as the debt ceiling debate this fall. The improving U.S. budget deficit (which has allowed S&P to upgrade its rating to stable from negative) takes some pressure off of Congress to act. Still, we wish that politicians, like doctors, had to swear an oath to "do no harm".

The Chinese stock market is imploding, as the transition to slower growth and tighter lending standards takes place. The year old regime leading the Community party has been true to its word on these matters. It is probably just rhetoric but still unsettling to hear the party instruct the Peoples Bank to attack the "four winds" of "formalism, bureaucracy, hedonism, and extravagance". Echoes of Mao.

In Europe, the German elections will be held in September which will indicate its policy direction toward the rest of the EU countries. The legality of the European Central Bank's ability to bail out the struggling EU nations is being tested in the German Constitutional court. Also, the coalitions governing Greece and Italy are barely hanging together.

Investors find themselves between a rock and a hard place. The "financial repression" of government mandated low interest rates forces risk taking, but now, the possible removal of stimulus suggests reducing risk. Whatever the outcome we remain committed to an overweight in conservative U.S. investments. If there is better economic growth, stocks will rise. If, on the other hand, there are negative shocks to global economies, the U.S. remains the safe haven to which money will flow.