Commentary
August 15, 2013

We are making our way through the “summer doldrums” and not much has changed. Corporate earnings and economic reports, for the most part, are positive if not vibrant. Investors have been able to slip away for a vacation without being terrified. Every year we hope fundamentals will again be the driving force for markets, instead of politics. While that is truer today than in several years, central bankers and elected officials continue to have a strong impact on financial markets. Furthermore, we are approaching an autumn full of potentially meaningful events that could result in unwelcome outcomes. S&P earnings, the economies of Europe, China, Japan and Canada all bear watching, but in the short term here are the developments we are following closely.

1. Fed Tapering – as mentioned in our last newsletter, the Federal Reserve has made public comments that, while it has no intention of tightening monetary policy or raising interest rates, a slowing in the pace of accommodative policy may be appropriate. That change will be data dependent on the state of the economy. Over the last month the Fed has tried to ease the transition by softening its original statements, yet each board member’s words are parsed extensively and have had a significant market impact. When the taper is a reality, whether or not as soon as September, it will likely be a negative for markets.
2. Budget Battles – the legislative and executive branches of the U.S. Government are no closer to working together to resolve the fiscal problems of the country. To be dealt with in the next two and a half months are:
    a. The funds to continue to run the government must be approved by September 30th or “non-essential” spending will cease.
    b. The sequester will continue to curtail spending and lower GDP if not emended.
    c. A budget for 2014.
    d. The Affordable Care Act is Obama’s flagship legislation and begins phase-in October 1st. Republicans want to it to fail so as to cut spending and to give Democrats a black-eye leading into next year’s elections.
    e. The debt ceiling will again have to be dealt with around the end of October, which will provide another chance for Republicans to demand spending concessions.
3. German Elections – September 22nd is the date and could reflect how the strongest member of the EU intends to continue to support the weak members. As an aside, Greece now has an unemployment rate of over 27% with 15 – 24 year olds over 66%. Greece’s economy shrank at a 4.6% rate in the second quarter and it was cause for celebration that it wasn’t worse. More bail-out money is required. Will German citizens protest?
4. New Fed Chair – we were perhaps too sanguine last month about the effect that a new Chair may have. Janet Yellen will most likely continue Barnanke policies, but Larry Summers is now more in the mix and he has spoken publicly about the ineffectiveness of the QE programs. Obama is unlikely to promote anyone with a restrictive monetary bent, but the market is sensitive to even subtle changes in the direction of policy.

While on the subject of central banking, the new by-word is “forward guidance”. With Fed fund rates near zero and diminishing returns from QE, the new tool is to promise to keep rates low for an “extended period”. It is do as we say time, since there is not much more the Fed can do.

On a lighter note, one other event for consideration; the sun’s magnetic field is in the process of reversing, as it does about every 11 years. This can stir up stormy weather on earth, and according to some can have an effect on people’s moods and thus influence how they perceive markets. While this theory smacks of others based on astrology etc., it happens that the Atlanta Federal Reserve Bank did a study in 2003 after the last flip with this conclusion: “*The authors find strong empirical support in favor of a geomagnetic-storm effect in stock returns*”. Oh dear.

Through history investors have switched to bonds when equities have had a negative impact on their net worth, the incorrect perception is that bonds are a risk-free asset. Over the last several months higher rates have led to losses in bond funds. It will be interesting to see the reaction as quarterly statements are received. We have already seen withdrawals from bond funds, which could translate into a move back into equities. Guru bond manager, Bill Gross of PIMCO felt the need to include in his latest letter “Stick with PIMCO”.

There are no internal signs that a significant market decline is in the offing. Valuation is not overly extended and earnings and economic reports remain positive. Still this bull is getting very long in the tooth, and as at the end of July, S&P earnings are up only 1% year-over-year while the Index itself is up 25%.

We remain invested, but are becoming more risk averse, and thus have increased our call writing activity.