September 2013 | SPECIAL FALL EDITION

Here We Go Again!?

By Louis E. Conrad II, CFA

Since the onset of the Financial Crisis in 2008, the federal government's actions (and inactions) have had an extraordinary impact on the capital markets. The most recent example was last week, when the Federal Reserve's Open Market Committee decided to maintain its current program of purchasing $85 billion per month in U.S. Treasury and mortgage-backed securities (MBS), surprising the markets, which had expected the Fed to begin to reduce (or "taper") its purchases. The announced delay in tapering led to a rally in the stock and bond markets that day, with the S&P 500 Index reaching an all-time high. Since then, however, the stock market has backed off slightly from its high, though the bond market's rally has continued (i.e., interest rates have fallen further).

The Federal Reserve's "Taper"

Market prognosticators now expect the Federal Reserve to begin the taper of its purchases of Treasuries and MBS late this year or early next year. The goal behind this program, commonly referred to as "quantitative easing," has been to bid up the prices of these securities in order to drive down their yields (interest rates). With lower interest rates, the U.S. economy would have a better opportunity to heal from the Financial Crisis and improve prospects for the job and housing markets.

While interest rates were driven to historically low levels and the job and housing markets have improved, quantitative easing is not without costs and risks. The Federal Reserve's balance sheet is approaching $3.7 trillion, whereas before the Financial Crisis, the balance sheet was about $1 trillion. These excess assets (i.e., Treasuries and MBS) have accumulated through the Fed's various quantitative easing programs.

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Though many believe the purchase of these excess assets has led to economic conditions that are better than they otherwise would have been, quantitative easing will ultimately need to be reduced and, ultimately, eliminated. This process will lead to a more self-sustaining economy, but also one that is more susceptible to economic shocks as interest rates return to more normalized levels and economic growth remains tepid.

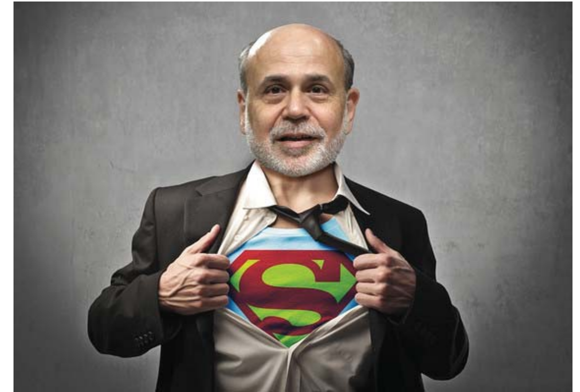
The Fed was reluctant to begin to taper based on recent economic data that had shown some softness, a recent increase in interest rates that had begun to slow the housing recovery, and the increasing noise emanating from Washington, DC, which could result in a deceleration of economic growth if consumer sentiment suffers.

Noise from Capitol Hill

The next few weeks will likely see an escalation of noise from Capitol Hill regarding the budget (the new fiscal year begins October 1) and the debt ceiling (Secretary of the Treasury Jack Lew has indicated that the federal government will reach its current borrowing capacity no later than October 17).

The most recent Congressional games of brinkmanship occurred at the end of 2012 over taxes (the "Fiscal Cliff") and in the summer of 2011 over the debt ceiling. Though the stock market effectively yawned in response to the 2012 year-end tax debate (the S&P 500 declined by 3%), the last meaningful debt ceiling debate in 2011 led to a roughly 18% correction in the stock market. In an article this month entitled "The Storm Before the Calm: Here Comes Another Debt Ceiling Debate," Fidelity states "after the August 2011 episode, investors have come to expect that last-minute negotiations will result in an agreement. Decisions to raise the debt ceiling in January 2012, January 2013, and May 2013 seem to have created apathy among investors. In fact, equity market volatility as measured by the VIX [see our article earlier this month in The COMPASS Chronicle for more on the VIX] has progressively declined ahead of each succeeding deadline….If financial markets react with heightened volatility, the likely causes will be geopolitical risk in the Middle East and Federal Reserve monetary policy actions, such as tapering its purchases of Treasury and mortgage-backed securities."

[Ben Bernanke photo by Terrence Horan of MarketWatch. Article continued on next page.]



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Capital Market Outlook

The S&P 500 Index has gained 27% since its recent low in November, 2012, and has generated a return of 20% year-to-date. I believe the stock market is due for a correction on the order of 5 – 10%. Though the noise from Capitol Hill could result in such a correction, I agree with Fidelity that the impetus is more likely to be Federal Reserve or geopolitical related.

Recent earnings growth has been only 4 – 5% year-over-year, but the stock market has surged higher as investors have been willing to pay more for each dollar of earnings (i.e., a higher price/earnings multiple) while interest rates declined and the economy expanded. In the face of higher interest rates, the price/earnings multiple accorded to stocks is unlikely to advance materially, unless the market discounts a lower risk environment, which I do not foresee.

Consequently, I expect stock price appreciation over the next 1 – 2 years to be closer to 5 – 7% annualized versus the 16 – 20% we have enjoyed in each of the past two years. Bonds will likely find an even more difficult environment if interest rates continue their upward migration. COMPASS has positioned client portfolios to weather a rising interest rate environment, where bond prices will be under pressure, by focusing on short- and intermediate-term holdings and avoiding U.S. Treasuries and long-term bonds, which are more susceptible to the deleterious effect of rising rates.

Long-Term Implications

I am more concerned about the long-term implications of the policies that have been pursued by the Federal Reserve and Congress. Unwinding the Fed's balance sheet is no easy maneuver and a miscalculation by the Fed could have serious consequences for our economy. On the other hand, Congress has demonstrated a clear inability to forge any clear fiscal policy—it has been noted only for its partisanship over the last several years. Meaningful tax reform awaits, as well as tackling our two largest entitlement programs, Social Security and Medicare.

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