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INSIGHTS

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2013 Q3 INSIGHTS:
The Timing of the Taper ~ Part II

RECAP: Last quarter, we outlined how the discussion regarding the potential reduction of Fed Chairman Ben Bernanke's Quantitative Easing program (QE) negatively affected global capital markets. Since then, due to statements out of the Federal Reserve, global financial markets almost unanimously anticipated that the central bank would start scaling back (tapering) its $85 billion/month purchase program late this quarter. The end of QE implied stronger economic growth—individual markets began to distinguish themselves and became uncorrelated instead of moving in lockstep as they did in Q2. From June 30th through September 17th, U.S. stocks rose 6.63% on the stronger growth outlook while U.S. bonds lost 0.63% as the yield on the 10-year Treasury rose another 50 basis points to approach 3.00%. And then the Fed met on September 18.

At the meeting, Bernanke not only downgraded the outlook for future GDP growth, but he also decided to leave the purchase program intact. Tapering was postponed for two primary reasons. One, the tightening of financial conditions (due to the rise in long-term Treasury and mortgage rates) threatened the recovery in housing and other interest-rate sensitive sectors of the economy. Two, while the unemployment rate had fallen from 8.1% to 7.3% in the last year, about a third of the decline was a result from a reduction in labor force participation versus the creation of new jobs. The unemployment rate essentially is down for the wrong reasons. What does all of this mean? In short, monetary policy will be more accommodative than markets had expected for a longer period of time. Thus, rates backed off from their highs and ended the quarter at 2.61%.

Last quarter we said, "markets will be fixated on the timing of Bernanke's 'tapering' for at least the next 3-6 months and probably longer as our easy and unconventional monetary policy will be difficult to unwind without adversely shocking the economy." The perceived number one job of the Fed nowadays appears to be job creation (whether the Fed can create jobs is another topic). So, any taper should come after a sustained period of improvement in the jobs market and corresponding unemployment rate, including other measures that consider the labor participation rate. Investors need to be cognizant about the monthly jobs report, which comes out on the first Friday of every month, as the major signpost going forward.

	Notable Sectors	Q3	Trailing Twelve Months
Stocks	**Global Equity**	**7.90**	**17.73**
	U.S. Large Cap (S&P 500)	5.24	19.34
	U.S. Small Cap (Russell 2000)	10.21	30.06
	International Equity	10.09	16.48
	Emerging Markets Equity	5.77	0.98
Bonds	**Global Bonds**	**2.80**	**-2.64**
	U.S. Aggregate (High Quality)	0.57	-1.68
	U.S. High Yield (Low Quality)	2.28	7.14
	International Aggregate	4.38	-3.39
	Emerging Market Debt	1.38	-2.12
Other	Gold	8.44	-25.19
	Oil	5.98	11.00
	Inflation	0.10	1.01

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EQUITY: Global Equity rebounded from the late-spring "taper tantrum" and subsequently moved to new all-time highs, returning nearly 8% for the quarter. International equity outpaced the U.S. for the first time this year. Looking overseas, Developed Markets (+11.56%) outpaced Emerging Markets (+5.77%) as Europe (+13.67%) outpaced most major global markets, adding credence to our "green shoots" metaphor postulated in Q2.

In the U.S., the S&P 500 reached its high for the year thus far at 1725 and finished the quarter in positive territory for the third consecutive quarter, while Small Caps outpaced Large Caps for the fourth consecutive quarter. Most reassuring was the reemergence of leadership from offensive cyclical areas of the market, as those assets typically should lead in a bull market. The defense-to-offense rotation was due in part to the lingering effects of the "taper tantrum," as most income-oriented assets trailed in the quarter. Growth stocks (+8.48%) outperformed higher-yielding Value stocks (+4.23%) and the Materials (+10.30%), Industrials (+8.91%), and Consumer Discretionary (+7.79%) sectors outpaced traditional defensive and high-yielding sectors such as Consumer Staples (+0.80%), Utilities (+0.19%), and Telecom (-4.40%).

FIXED INCOME: Global Bonds broke their losing streak and gained 2.80% for the quarter. Similar to equities, gains were more pronounced in more aggressive sectors such as High Yield (2.28%) and Emerging Market Debt (1.38%). More conservative defensive sectors lagged as the Aggregate U.S. Index returned 0.57% and Intermediate-Term Treasuries posted a flat quarter.

ALTERNATIVES: The rotation out of higher-yielding stocks also negatively affected alternative assets as MLPs (-0.73%) lost ground in the quarter. REITs (-3.00%) took an even bigger hit, losing ground for the second quarter in a row. Commodities rebounded from a dreadful Q2 and gained 2.13%.

OUTLOOK: In the short run, unfortunately, the focus is back on Congress as the government shutdown wreaks havoc on the country and the Continuing Resolution and Debt-Ceiling debates loom ahead. Chatter out of Washington is once again acrimonious, and although we do not expect an outcome similar to 2011, it is an increasingly concerning situation that will be watched closely.

In the long run, the ability of global GDP growth (and corresponding jobs creation) to live up to current projections will have a meaningful effect on stocks and bonds. There are encouraging data points around the globe, however. Europe is showing an improvement in economic data and its era of austerity is winding down, which should set the stage for positive economic growth in the quarters and years to come. A healing Europe will further boost its leading trading partner, which is China. This will add fuel to an already improving economy as the emerging market recently posted improving data for the second straight month. Meanwhile, Japan is bolstering their markets with experimental monetary policy of their own—all in an attempt to reverse long-entrenched de¬flationary pressures. Finally, the U.S. economy should strengthen as the effects of the fiscal drag diminish in 2014. But time and time again, overly optimistic GDP estimates from the Fed have failed to live up to expectations. Perhaps we will look back and see that Bernanke's move was an attempt to outsmart Congress and that the extension of QE was his last insurance policy to ensure his legacy.

Sincerely,
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