MV Capital Management Weekly Market Flash

Rehab? Investors Say No, No, No

June 14, 2013

The doctors may be at odds about how and when to start reducing the morphine treatment, but the patient is having none of it. When Dr. Bernanke chose to use the word "tapering" during the Fed's May 22 meeting, carry trade investors of all stripes heard the flow of their daily stimulus fix (the low rates that finance their profitable adventures into risk assets) threatening to slow down to a measured drip-drip. We won't go, go, go they chorused as prices on US stocks and emerging markets bonds and global REITs and much else besides jagged to and fro in increasingly volatile trading sessions.

It's still all about the Fed. When the S&P 500 jumped up by 1.5% on Thursday of this week it was an unconfirmed report in the *Wall Street Journal* implying that the Fed wouldn't be backing off its QE3 operations any time soon that set the bulls on the charge. Whether yesterday's sudden burst of optimism sets the pace for a sustained push back towards the index's May 21 high water mark of 1,669 probably depends more than anything else on how Bernanke chooses to articulate the central bank's current thinking at the forthcoming Board of Governors meeting this next week. Here's a thought: It is rather unlikely that the word "tapering" will venture forth again from his calm and measured lips.

An Interim QE Report Card

With the myopic focus on day to day movements in asset prices it is sometimes easy to lose sight of the fact that the Fed's policy tool of choice, quantitative easing, is primarily aimed at the more pressing objective of bringing the economy back to health – as defined by growth in economic output, income and especially employment. The theory underpinning QE is that by driving asset prices up, monetary policy engineers can encourage the wealth generated from the higher values to spill over into the economy at large. That theory may prove valid in the end, but the jury is still out.

So far the post-2009 recovery has failed to produce a single full calendar year of 2.5% growth, which is a benchmark level for sustainable (albeit moderate) job-creating growth. The unemployment rate has fallen from a high of 10% year-on-year reached in October 2010 to 7.5% in April 2013 (ticking up again slightly in May as more out of work adults came back into the market looking for jobs). That is an improvement though the pace is slow. After the recession of the early 1980s unemployment fell from 10% to 5.5% by the second half of the decade. At current GDP growth rates that will be tough to match.

Look Ma, No Hands

Recent news has given reason for optimism, though. Payroll numbers have been trending up as of late, consumer confidence is resurgent and housing price gains are shoring up household balance sheets. Perversely, it's the optimism of recent data points that have added to investors' funk. It's when signs of better health appear that the doctor starts to wean the patient from the treatment. At least for now the patient is not ready, and it's unlikely that the doctor is going to push him out the door too quickly. That's probably the right thing to do. But the concern is that when the body gets too used to the treatment, the treatment becomes less and less effective. And that in turn could call into question the course of the recovery. Dr. Bernanke has a fine line to walk this coming Tuesday, and both his policy choices and his verbal acuity need to be sharp as a tack.

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