MV Capital Management Weekly Market Flash

Steady Tack into Taper Week

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By the end of the business day next Wednesday we will know more than we know today about what specific course of action the Fed plans to take – if any – to begin the process of weaning markets off the QE drug to which they have been hooked up for the past several years. While there is much debate about whether QE has made any difference to the lives of working Americans, or to business capital formation or bank lending activity, in one metric there is precious little doubt. QE has lifted risk asset markets and been the primary tailwind behind the bull market that began in 2009 and technically became – at least for now – a macro growth market when the S&P 500 sailed first past its 2000 and then 2007 high back in March of this year. The foremost question among market observers now is whether the smooth sailing can continue once the training wheels come off. So far, at least, key indexes are tacking into next week's decision with a steady hand.

What's At Stake

Two things are <u>not</u> going to happen next week. Interest rates won't go up, and QE won't come to an abrupt end. The Fed has put out clear metrics in this regard: QE should not wind up completely while the unemployment rate is still above 7% (currently it is 7.3%) and overnight rates should not go up for any reason until it falls at least to 6.5%. That's probably still quite a ways off. So what's at stake next week is simply whether the Fed will announce that it plans to reduce by some amount the $85 billion of fixed income securities (government and mortgage backed issues) it purchases every month, what that "some amount" might be, and whether or not that will be evenly split between govvies and MBS.

Illusory Calm?

Some observers would appear to see the current firmness in risk asset prices as illusory. According to a recent *Wall Street Journal* survey of 47 economists, 66% believe that the Fed will start tapering in September, but 40% also believe that the market hasn't fully priced in the effect of tapering. In other words there is a possibility that if, for example, the Fed announces that it will immediately start cutting back QE by $15 billion per month (which is the average amount the *WSJ* economists surveyed expect) the market could be surprised and react sharply. That's rather unusual given how much the topic of QE tapering has dominated the financial conversation in the past couple months.

Never Say Never

On the other hand, even a definite tapering move doesn't necessarily start nailing the QE coffin shut. Bernanke has made it clear that the Fed remains ready to do anything and everything necessary to bring about the desired economic improvement. If something comes along – a government shutdown or another debt ceiling fiasco that roils markets – it's not hard to see the Fed reversing course and buying up more bonds. The age of moral hazard is probably with us for some time still to come, and the steady course markets are maintaining this week seems to indicate that most participants don't see the "Fed put" disappearing anytime as far ahead as the eye can see.

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