MV Capital Management Weekly Market Flash

Taperphobia

September 20, 2013

Sapiens est, qui omnia pacata mente tueri potest
(Wise is the person who can regard all things with a calm and tempered mind)

With apologies to Lucretius for the slight paraphrasing of his great insight from "The Nature of Things", it would be nice if there were more calm and tempered minds out there observing markets and making policy decisions. Unfortunately we got the opposite of calm and tempered this week, with the Fed announcing that it would not begin to taper back from the $85 billion of monthly asset purchases that form the core of its monetary stimulus program. More than ever, QE3 really does live up to its nickname of QE4ever. What happened this week is significant and deserves much more than the brief commentary we can provide in this week's Market Flash. So this is the first of a series exploring what is behind "taperphobia" and how it may impact investment markets in the weeks and months ahead.

Bernanke, Spooked

Since late May of this year the Fed has appeared to be guiding us towards the first baby steps away from dependence on quantitative easing for risk asset performance. Up until this past Wednesday the guidance seemed to be working. Yes, the S&P 500 experienced a 5.7% pullback for a month in late May and June. Yes, the 10-year Treasury yield went on a rampage from 1.5% to just under 3% -- a run-up almost entirely unjustified by the fundamentals. And yes, the economy continues to grow only sluggishly – but it does continue to grow. We have not drawn close to the precipice of another recession. Corporate earnings are still close to or at record levels. Yet at the last minute Bernanke blinked. Out the window went all that careful guidance from the last four months. Investors and professional market commentators around the world are scratching their heads – and the confusion is nearly universal – and trying to figure out exactly what spooked the Fed.

Shutdown Scenarios

One issue to which Bernanke made explicit reference in his remarks on Wednesday was the next installment of Washington dysfunction. A possible government shutdown looms at the end of this month, and another fight over the debt ceiling limit is on deck shortly after that. The battle lines are drawn and appear to be more partisan and irreconcilable than ever, if such a thing is possible. So one view is that the Fed felt the need to keep the money spigot open to ease the pain if Republicans and Democrats take this one to the mat. That said, it's a bit hard to understand how the decision to keep buying $85 billion in bonds versus $70 or $75 billion (the expectation was for a taper of $10-15 billion) would offset the effect of the government ceasing its daily functioning or the US not paying its debt obligations for the first time in the history of the Republic.

Let Markets Be Markets

In the immediate wake of taperphobia stock markets soared. The S&P 500 and other major market indexes leaped to new record highs. Now let's be serious – as managers of mostly long-only portfolios of diverse risk assets we generally like it when the market goes up. Our clients win, Americans across the country with 401(k) plans win, and that's a good thing. But Wednesday's record closings did not feel good to us – in fact we were left with a rather queasy feeling, more like the feeling we have after a day of big losses.

We feel this way because we believe that, to the extent possible, markets need to be allowed to…well, be markets. "Being a market" means to continually price in new information and adjust to that new information, up or down. Do markets overreact? Of course. As we noted earlier, there was no basic economic reason for the 10-year yield to soar to 3%. But we also don't think that the economy will collapse into itself with the 10-year at 3%. At the beginning of 2011 that rate was over 3.25%. The historical average of the 10-year yield since the end of the Second World War is a bit over 6.1%. A 3% yield, in our opinion, is not sufficient cause to panic and reach for the next morphine injection.

Getting Off the Drug

We have our concerns about the economy, about government dysfunction, about the upcoming earnings season – all the things that keep our minds focused each and every day. But those concerns are magnified, not mitigated, when we get signals from policymakers reflecting a lack of faith in the integrity of market mechanisms to work on their own. Right now markets are addicted to easy money. Addiction in any form is hard to break, and the longer it goes on the harder it gets. We are optimists by nature and we believe growth will return – but we need to start letting the system find its own legs.

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