MV Capital Management Weekly Market Flash

Economic Cheer vs. Taper Tantrums

December 6, 2013

Just in time for the holidays, recent headline economic news should bring on a rush of good cheer. Nonfarm payroll gains have topped the critical 200,000 level for three of the past four months, while the unemployment rate has fallen to 7%. GDP was revised upward for the third quarter to 3.6%, the highest it has been for two years. Inflation is nowhere to be seen. The housing recovery continues apace. These all make a reasonable case for a return to more normal levels of growth than we have seen for a while.

Good news. Except, that is, for the folks who are too busy throwing a “taper tantrum” to notice.

The $85 billion question

The market opened sharply higher today, largely on news of the jobs numbers, but prior to that the S&P 500 had lost ground for five days in a row. The building signs of economic growth took traders to the dark place where fears of a reduction in the $85 billion monthly bond purchasing program trump all else. The Fed meets again on December 17-18, and taper fears are running high. Nor are stocks the only asset feeling the chill. It is a rare sight to see bonds underperforming stocks on a day when stocks are down, but that has happened several times recently. Even though the Fed has no intention of raising rates any time ahead as far as the eye can see, and there is little in the way of fundamental upward pressure on rates, the equation “taper = rising rates” is lodged firmly in the mind of the market.

Six of one, a half dozen of the other

So are the taper fears grounded, or is this just another irrational outburst from the denizens of Prozac Market, kicking and screaming their way to rehab? Will the Fed actually start tapering and, if so, will that necessarily be a bad thing? These are hard questions to answer, because the answer largely depends on whether the recent growth trend has durable traction. The dismal scenario that keeps the Board of Governors members up is the combination of anemic growth and ultra-low inflation. That’s the combination that has people tossing around terms like “lost decade” and “Japan 2.0”.

But if 3%-plus GDP and below-7% unemployment are in fact the new normal, then the assumption is that a healthier inflation rate of 2 – 2.5% will follow in due course. Under those conditions, the QE training wheels should be able to come off without major disruptions. So the Fed’s dilemma is about how much trust to put into the growth story, and whether the data are strong enough to justify a December taper.

The cautious Fed

The deliberating style of this Board of Governors is cautious, and caution will continue to be the watchword. That caution was in full view in September, and it came through loud and clear in the recent confirmation hearings of soon-to-be chairwoman Janet Yellen. A read of the tea leaves still probably points to a higher likelihood of no taper action in December. But the growth numbers do matter. At the very least, we should expect to see something in the meeting minutes that incorporates the growth scenario into future intentions. In an ideal world, the Fed could communicate these intentions in a way that makes clear that (a) tapering policy does not equal rate hike policy, and (b) they will turn the spigot back on if future economic conditions so warrant.

But we don’t live in an ideal world, and chances are that we’ll have to endure more taper tantrums as the weeks continue. At some point, though, we would expect that the good growth numbers, should they continue, will gain the upper hand in the market Zeitgeist.

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