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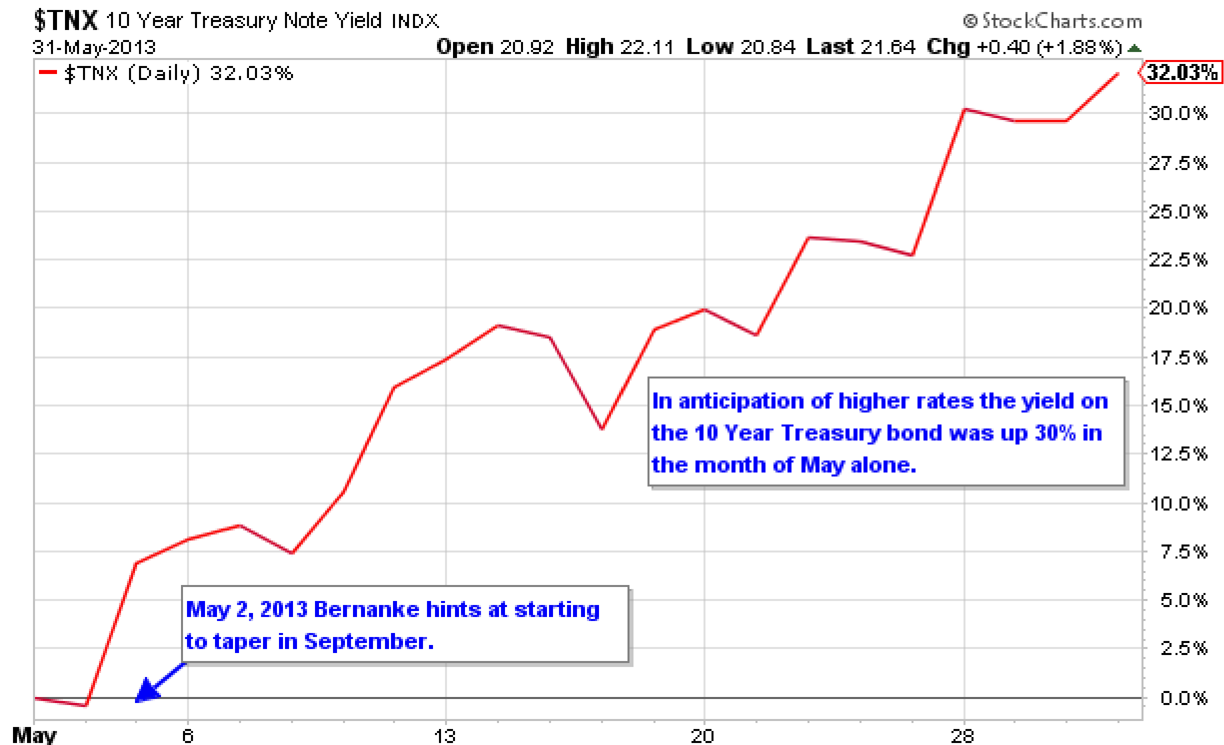
"Governments have a tendency not to solve problems, only to rearrange them."
Ronald W. Reagan

On To The Next Crisis

Despite September's near U.S. military intervention in Syria, Bernanke's change of heart regarding tapering and Miley Cyrus' "performance" at the MTV music awards, the U.S. markets are still near all-time highs. However, stocks are now facing a potential government shutdown over the decision to once again raise or not raise the debt limit. Both political parties view this fight as either an opportunity to advance or defend their agenda. Using the country's debt limit as leverage is a very risky game of high stakes poker both politically and economically due to the inherent uncertainty. With that in mind, let's first review the logic behind the Fed's most recent decision. Second, we'll discuss how the threat of or actual government shutdown might impact investors.

To Taper Or Not To Taper

In case you're someone who does not relish reading financial publications, the U.S. bond buying program, also known as quantitative easing (QE), is meant to stimulate economic growth by holding down interest rates and thus encourage individuals and businesses to borrow, spend and invest. This program has received a great deal of the credit for home sales. It has also enabled some companies to borrow cheaply and use those funds to purchase stock and raise dividends. This is beneficial for investors in the short term but has not created the jobs the government was hoping to stimulate. Given the dollars committed and an optimistic forecast for US growth, Fed Chairman Bernanke signaled in May of this year that the central bank *might* pull back on the bond buying program. The impact on rates following his comments was dramatic as illustrated below.



Bernanke's reasoning for his words in May were understandable. Based on the data they review, the job market was improving gradually and the Fed anticipated faster growth by year end and into 2014. Rather than risk over heating the economy, he indicated the Fed may purchase fewer bonds and thus begin the process of removing Fed involvement in setting rates. To use an analogy, think of Chairman Bernanke running alongside a child (US economy) learning to ride a bike. Once he stops running and offering minor support will the child continue down the road brilliantly or swerve into a mailbox or ditch? Based on the decision not to taper at the September meeting, Bernanke feared the second.

What changed between May and September? Simply put, a falling unemployment rate did not represent the true state of the economy. Rather a falling labor participation rate to levels last seen in the 1970's and more meager earnings reported by companies were viewed by the majority of Fed officials as reason to keep a foot on the gas.

The Fed's decision to maintain the status quo surprised just about every market expert who made the mistake of giving their opinion prior. To quote PIMCO's president Mohamed El-Erian, "This week (of Sept. 18th) should remove any doubt about whether the markets are highly dependent on the Fed." El-Erian's comments are supported by the charts below.

Being overly optimistic about the future is apparently as common at the Fed (about the economy) as it is with parents (about Junior). Yes, Junior should be able to get back on the bike after hitting the proverbial mailbox, bruised but independent. One could argue removing support a little early is far better than too late. However, higher rates, meager growth and a looming budget battle were likely more headwinds than the Fed was willing to risk facing. Thus, QE III rolls on until the Fed sees the type and rate of growth which inspires confidence.

High Stakes Poker Congress Style

As investors and citizens, there are actually two dates to keep in mind: the Sept. 30th deadline to pass legislation that funds the government in the coming fiscal year and the mid-October deadline to raise the federal borrowing limit. As every frustrated citizen is aware, this is not the first debt ceiling battle the country has faced. We can gain some insight into how markets react prior to and recovering from a debt ceiling ***scare***. I stress scare because we cannot point to a past example of how markets react to a U.S. technical default. Let's take a look at the situation back in 2011, when the threat of a government shutdown existed and how the market reacted:

So what does all of this mean to us? For one thing it serves as a reminder that Wall Street and the markets in general are lousy at predicting the future. To quote Warren Buffett for the second quarter in a row: "We have long felt that the only value of stock forecasters is to make fortune-tellers look good…" Diverging from a well-constructed investment plan based on market or political predictions rarely ends well.

Second, volatility is here and here to stay for the foreseeable future. As we've discussed in the past, volatility calls for ongoing assessment of the quality of our clients' portfolios in addition to ensuring there is cash on hand to take advantage of market pullbacks for appropriate accounts.

In closing, our firm continues to be forward looking while not forgetting history's lessons. A balanced approach is as important in the current market as it has been in the past, if not more so. Our mission remains to build diversified portfolios for our clients capable of achieving much of the upside of stocks but with better downside performance when the fickle markets decide to change course. We look forward to continuing this discussion with each of you and thank you for your ongoing confidence in our services.

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