MARKET THOUGHTS | 12.18.2013

Capital markets reacted to today's U.S. Federal Reserve statement and subsequent press conference, with most riskier asset classes sharply higher. In what was likely Chairman Ben Bernanke's final address as his term is expected to end this coming January, the Fed chief explained the central bank's decision to begin "tapering," or slowing down the amount of treasury and mortgage bonds it has been purchasing through a program that began its most recent iteration in September 2012. This decision is grounded in the Fed's expectations for further economic progress, which reaffirms our "glass half full" mantra when communicating with clients over the past several months. We are encouraged by riskier asset class performance in the wake of this decision and momentum heading into 2014, but we remind clients to respect potential risks heading into the New Year. We will briefly cover today's events before discussing implications.

Today was a busy day at the U.S. Federal Reserve, marking the conclusion of a two-day Federal Reserve Open Market Committee meeting, issuance of a statement regarding policy decisions, release of Federal Reserve economic forecasts, and, finally, a press conference from Chairman Bernanke. The decision to slow down the rate of bond market purchases by $10 billion per month is clearly the headline event, with many market prognosticators expecting the Fed to delay this wind-down until January or even March. The Fed cited an improved job market as the key reason for its action, indicating that it initiated the bond-buying program to restrain lending rates and, in turn, encourage companies and consumers to borrow, stimulating the economy and employment. In his press conference comments, Chairman Bernanke cited that he and his fellow committee members expected recent labor market improvements to continue into 2014.

The Fed was careful to indicate that today's actions should not be interpreted as tightening or reflecting the central bank's desire to discourage lending or slow down economic growth; the Fed was careful to point out that it will keep its target for bank lending rates near zero even when the unemployment rate falls below 6.5 percent, a level it expects to see at some point in 2014. Bernanke and his counterparts see the bond-buying program as being "supplemental" to the Fed's main policy tool of targeting short-term interest rates, with the latter carrying a larger impact on capital markets than the bond purchase program. Further, rate forecasts from the Fed suggest that it's not likely to raise rates until the latter part of 2015 and that any rate hikes will be gradual; strengthened forward guidance was one of the reasons for today's positive market reaction.

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The committee's forecasts reflect a positive economic growth picture, but one that remains somewhat sluggish and still requiring the nudge that low interest rates can provide. Low inflation, actual results at the consumer and producer level as well as subdued future expectations, are symptomatic of a still-fragile economy, with actual and expected inflation both below the Fed's two percent target. A modestly improving job market alongside stubbornly low inflation presents a mixed picture for policy makers like the Fed, so a pragmatic, gradual tapering was welcomed by investors.

What does today's action mean for investors? Our initial take (looking beyond today's price movements across asset classes) is that this remains an equity market-friendly environment. When global markets reacted to hints of tapering in May and June, several asset classes – particularly those tied to emerging markets – reacted negatively and while one day does not make a trend, the Fed's pragmatism was cheered as measured by broad emerging market indices across both stocks, bonds, and select currencies, areas that have a lot of potential "catch up" relative to U.S., European and Japanese equity market performance in recent months.

The bond market implications are less clear, and intraday gyrations across bond sectors today indicate fixed income investors remain unsure of how Fed actions translate. One potential outcome is that the bond market is losing a consistent demand source in the Fed, and by implication less demand means lower prices and higher yields. Another plausible scenario is that since the Fed is tamping down its bond purchases by a very gradual amount and inflation remains very low, bonds will not be susceptible to a Fed wanting to reverse "easy" monetary policy through shutting down its bond purchase program and raising short-term interest rate targets in rapid fashion, making them more attractive. Regardless, the bond market may have already priced in some tapering as the 10-year treasury yield has been moving back towards three percent recently. Whatever scenario unfolds, bond yields remain near historic low levels, and while they still serve an important role within a diversified portfolio, being more selective within the asset class will likely produce better outcomes than owning a broad basket of traditional fixed income instruments.

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We retain our “glass half full” assessment when weighing issues surrounding capital markets and economies. We also remind investors that a growing economy with low inflation does not necessarily set the stage for riskier asset classes to continue their ascent higher; given such a strong run in global stocks since the March 2009 lows, valuation will likely hold a greater weight in investors’ decision making, especially in an environment where the Fed is adding less liquidity and expects to conclude its bond-buying program at some point next year. We are encouraged by developments out of Washington regarding the two-year budget deal, ongoing improvement within Europe and Japan, as well as the gradual transition by many emerging economies (most notably China) to more sustainable growth sources. We are also mindful that political brinksmanship remains high, valuation could become stretched, and the “unknown unknowns” constantly surround markets. We will remain vigilant in assessing the opportunity set for our clients across the businesses that we service.

As CAPTRUST’s Chief Investment Officer, my team and I remain committed to helping you achieve your goals as we close out 2013 and look forward to the New Year. We wish all of you a happy and healthy holiday season and all our best for 2014!

Onward-

Eric

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