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Greetings,

People who know me well are aware that I am an old movie buff. While "The Graduate" is not exactly one of my favorites, it is still a notable movie for many reasons. There is a scene where the character played by Dustin Hoffman is talking to a family friend at his graduation party about his future. The friend says to Hoffman's character "Remember plastic". As far as the stock and bond markets now, the key word to remember is "Taper". You will be hearing this word constantly. People in the financial media have been using this word in reference to the fact that the Federal Reserve will eventually be reducing (Tapering) the amount of QE. QE as a reminder, is short for quantitative easing. Quantitative easing is the term to describe the action that the Federal Reserve is taking to keep long term interest rates artificially low by printing money to purchase fixed income securities in the open market. There is talk that the Fed is responsible for two thirds of the Treasury bond purchases, which in my view is huge. Recently, Ben Bernanke (after the last Fed meeting) indicated that if the economy shows the improvement that it expects to see, then the Fed will "Taper" its bonds purchases sometime in the fall. What is key is that Bernanke said that it will "Taper" if the economy improves as it expects it to. He didn't say that the economy is improving. At this point in time, any improvement in the economy is minimal. The first quarter GDP was just revised down to an annual growth rate of 1.8%, from 2.4%. The second quarter GDP isn't supposed to be much better than 2%, if that high. The Federal Reserve believes that there will be some improvement in the second half of the year, which is now. With a GDP growth rate of 2%, it certainly won't take much to show some kind of improvement. I should note that the Federal Reserve is notorious for being a poor forecaster of economic conditions. Several years ago, the Fed was forecasting 3%+ annual growth for this year. The Fed was too slow to react back in 2007 and in early 2008. What we have now is easily the worst economic recovery since World War 2. Historically, the stronger the recession, the stronger the recovery. Remember that $ 800 billion (or so) stimulus package from a few years ago? How much has that helped?? All of this liquidity (money printing/QE) has also done very little if anything to help "main street" but it has helped the stock market that is for certain. With annual GDP growth barely above recession levels and an unemployment rate at 7.6%, I just don't see the Fed as being anxious to actually slow down its bond purchase program. I can see them doing a lot of talking about "Tapering".

Since the latest jaw boning by the Fed, many people have said that the stock market is like a drug addict and QE is the drug. Once the drug (QE) is removed, the addict (the stock market) reacts violently with its serious withdrawal symptoms. Some people are saying that if the stock market is reacting this badly now, then it will really get messy once QE does stop. I must state that I don't think that the stock market has been reacting that badly. The market was off to a torrid start to the year and a 4% pull back over a couple of weeks is really not a big deal, if anything, I found it rather healthy. What I find unhealthy is how the market is reacting on a day to day basis simply on some comments by some Federal Reserve members. I believe personally that actions speak louder than words, but the market is reacting on every word spoken by these Fed members. The much anticipated market correction apparently was halted in its tracks by some recent comments by some Federal Reserve members, when they said that the markets overreacted to Ben Bernanke's comments after the last Fed meeting. In most circumstances, the anticipation is worse than the reality. More importantly, there is no way, no how that the Federal Reserve will stop QE unless the economy is showing significant improvement. Just as important is that stopping QE is not the same as raising short term interest rates. Stopping QE is like easing up on the gas pedal. Raising short term rates is like hitting the brakes. While I can see QE being over some time next year, I will be shocked if short term interest rates begin to rise before 2015 which is 2 years away. Depending on who the new chairmen (or chairwoman) of the Federal Reserve is, I can see short term rates staying at near zero well into 2016. If anything, I think that the Fed will be fearful to put the economy back into a recession by raising rates too early. I also think that a Fed "dove" such as Janet Yellin (the head of the San Francisco Fed) will replace Ben Bernanke in January and a Fed "dove" will not want to shake the financial markets up.

In my previous investment letters, I have written about the bond bubble. I don't know for certain but it appears that the bond bubble has finally burst. It has at least with Treasury and junk bonds. I read in a recent edition of the Wall Street Journal that there is so little liquidity in junk bonds that some bond traders couldn't even sell some low rated bonds that they were holding. What could make things nastier is that the selling in bonds will lead to more selling because the owners of these bond mutual funds (which are where so many retail investors moved their money from stock mutual funds the past several years) aren't used to seeing their fixed income investments go down, even over the very short term. Equity investors, for the most part understand that the markets go up and down and that there will always be a few bad months along the way. Investors in bond mutual funds simply don't have the same mentality (or expectations) and once they see two consecutive months of losses, they most likely will do some selling which will push bond prices lower and yields higher.

If you have any questions on anything or if there is anything that you want to discuss, please either call me or send me an email