

U.S. and global equities were under pressure last week, with all major U.S. indices lower for only the fourth time this year. With discussion of the Fed tapering its stimulus, market uncertainty gained momentum. The S&P 500 was down 1.0% for the week.<sup>1</sup> We consider the market pullback technical in nature since the mention of a Fed quantitative easing exit likely created a natural point to take profits after the recent rally.

## Timing is Everything

Although the markets declined in response to Fed signals, this does not change our view of the fundamentals for growth, inflation, earnings and policy. Tapering and eventually stopping quantitative easing (QE) is not a tightening of monetary policy; it is just a reduction in (and end to) the pace of easing. Markets are highly sensitive to changes in the Fed's QE and zero interest rate policy. This is not because those changes are the main driver of global growth and inflation but because they would reverse the easy money environment that has driven asset reflation over the last several years. Easy money has boosted asset prices and helped to pull the global economy out of recession. Once the world economy reaches a level of escape velocity, monetary stimulus can be taken away, and the economy can take over as the driver of asset prices. If things go as planned, the handoff should be relatively smooth.

We do not think the Fed's message is as controversial as it has been made out to be. Economic conditions have improved, and if the present path continues, tapering would probably be appropriate later this year. But the Fed wants to ensure the improvement is sustainable through the summer and fall. In addition, the Fed is cognizant of the U.S. fiscal tightening and wants to ensure the economy can withstand this headwind. Quantitative easing isn't going to zero soon, and it may be months before Fed purchases dwindle. Also, the potency of QE could actually expand (even if the \$85 billion per month declines) because of the lower federal budget deficit.

We believe investors are anxious about an end to Fed assistance because they lack economic confidence. Since 2009, the Fed has been clear about open-ended policy, supported by the recent message from key FOMC leaders. There is no pressure on policy from the perspective of the Fed's two mandates: 1) Inflation is below target and 2) unemployment is still too high to warrant taking economic risk. The Fed is unlikely to cause a U.S. inflation problem in the next two years, but the consequence of its policy has been inflationary around the world, primarily in the form of asset inflation. The Fed will only pass the baton to the private sector when it believes



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confidence has been restored, and growth is self-reinforcing to weather the market turbulence associated with moving from hyper-accommodative to accommodative policy. Earnings will then become more critical to drive equity prices. This transition to a neutral policy will be historically slow. Bottom line: we believe the Fed is not ready to scale back the degree of accommodation and will wait for more data to confirm a sustainable recovery.

## Calm Interrupted

On Thursday, the Japanese stock market declined 7% and other markets sold off significantly. Theories about the cause include: 1) U.S. Fed Chairman Ben Bernanke's comments, 2) a disappointing China Purchasing Managers' Index (PMI) or 3) the Japanese 10-year government bond yield touched 1%. Selling in Japan was aggressive because of an overbought condition. A steady, grind-higher environment for all equity markets had lulled investors into a false sense of calm, setting the stage for a reversal.

As far as U.S. economic activity, consumer spending has held up in spite of the payroll tax increase. However, weak government spending and soft demand abroad have offset this positive surprise. In our opinion, the likelihood of renewed sharp fiscal shocks has declined with the federal budget deficit decrease. Inflation is falling in many countries, with U.S. core inflation at 1.1%,<sup>2</sup> a lower level than the past three times in 11 years when the Fed has justified easing programs.

In conclusion, a short-term cautious stance might be advisable given negative headlines and potential market volatility. Yet the U.S. equity bull market retains its key tenets. We believe that growth potential for the U.S. is supported by a revival in manufacturing competitiveness, a rebound in housing and the trend toward energy independence.

## 2013 Performance Year to Date

	Returns	
	Weekly	YTD
S&P 500	-1.04%	16.67%
Euro STOXX 50	-0.91%	5.57%
FTSE 100 (UK)	-1.33%	7.08%
DAX (Germany)	-0.40%	6.60%
FTSE MIB (Italy)	-1.79%	3.37%
Nikkei 225 (Japan)	-1.57%	20.67%
Hang Seng (Hong Kong)	-1.67%	0.55%
Shanghai Stock Exchange Composite (China)	0.49%	2.71%
MSCI World Ex U.S.	-2.81%	8.58%
MSCI Emerging Markets	-1.83%	-1.52%

Source: Morningstar Direct and Bloomberg, as of 5/24/13. All index returns are shown in U.S. dollars. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indices are unmanaged and unavailable for direct investment.

*"The Fed will reduce the degree of stimulus only when it feels confidence has been restored and growth is self-reinforcing. Earnings will then become more critical."*

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<sup>1</sup> Source: Morningstar Direct, as of 5/24/13. <sup>2</sup> Source: Bureau of Labor Statistics, "Consumer Price Index - April 2013," May 16, 2013, <http://www.bls.gov/news.release/cpi.nr0.htm>.

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. **Euro STOXX 50 Index** is Europe's leading Blue-chip index for the Eurozone and covers 50 stocks from 12 Eurozone countries. **FTSE 100 Index** is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange. **Deutsche Borse AG German Stock Index (DAX Index)** is a total return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange. **FTSE MIB Index** is an index of the 40 most liquid and capitalized stocks listed on the Borsa Italiana. **Nikkei 225 Index** is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. **Hong Kong Hang Seng Index** is a free-float capitalization-weighted index of selection of companies from the Stock Exchange of Hong Kong. **Shanghai Stock Exchange Composite** is a capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. **The MSCI World Index ex-U.S.** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets minus the United States. **The MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

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