CHART OF THE MONTH

JUNE 2013

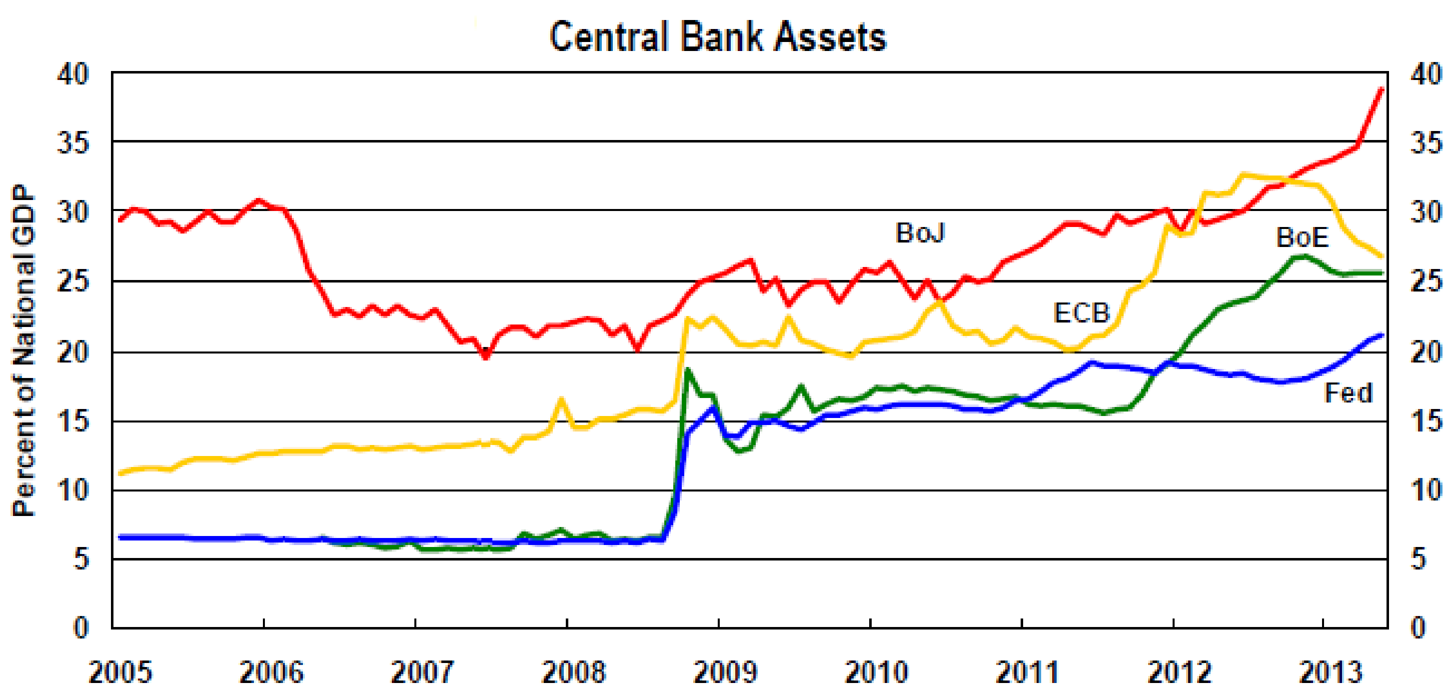
In what many have called the Taper Tantrum, the stock and bond markets underwent a two-day rout in the aftermath of the Federal Reserve statement and Chairman Ben Bernanke's press conference on Wednesday that hinted at the possibility of a somewhat less-accommodative Fed in the near future. Stock prices tumbled approximately 5% with the Dow Jones Industrial Average falling below the 15,000 milestone and the Standard & Poor's 500 piercing the 1,600 mark. At the same time, the yield on the 10-year Treasury ballooned to 2.50%, its highest level in nearly two years.

Despite concerns about the expansion of the Federal Reserve's balance sheet over the past five years, we believe the Fed still has room to facilitate the economy and the financial markets. As shown in the graph below, the Fed's assets as a percentage of National GDP is much lower than the Bank of England (BoE), European Central Bank (ECB), and Bank of Japan (BoJ). The vast majority of the escalation was in late 2008 when the financial system was on the verge of collapsing. The subsequent increases have been essentially in-line with the growth in the economy, whereas the other central banks have been much more aggressive with little or nothing to show for their efforts.

Meanwhile, the Fed has *not* been printing money as the conventional wisdom suggests. During the first quarter, the Fed purchased approximately $280 billion in Treasury and mortgage-backed securities (equal to the stated monthly pace of $85 billion plus the reinvestment of maturities and coupons), yet the money supply (M2) *declined* $55 billion. While the first three months of the year may have been a slight anomaly, M2 has been growing at a reasonable annual rate of 6 to 7 percent, which is roughly in-line with its 20-year average. However, the velocity of money (also known as turnover) has fallen to historically low levels due to the fact that banks have been content with holding the majority of the reserves that the Fed has created, dampening the yearly advance in real GDP and inflation to less than the central bank's targets of 3.0-3.5% and 2.0%, respectively.

At a monthly pace of $85 billion (which amounts to roughly $1 trillion over the course of a year), the Fed has basically been buying back the equivalent of the deficit. With the run rate on the latter down to around $850 billion (and likely to decline further), the Fed can reduce the amount of its purchases accordingly. Nonetheless, we expect that the Fed will continue to keep its proverbial foot on the gas pedal – albeit at perhaps less than full speed – until the aforementioned targets are achieved. Any speculation to the contrary is simply unfounded.

Importantly, investors should treat the unwinding of the Fed's Quantitative Easing as good news because it will mean that the outlook for the economy is getting better, not worse.



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