Weekly Market Commentary

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The End Is Near — But That Is Good News

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Highlights

What market participants heard from the Fed last week — that it is ready to soon end the bond-buying program — overwhelmed what the Fed said about how it plans to continue to expand its purchases at a slower pace.

It appears the stock market started to move to price in the start of tightening rather than the potential end of stimulus.

The knee-jerk reaction of selling across all markets — stocks, bonds, and commodities — may not persist for long and could create opportunities to buy the dip.

Market participants reacted as if The End is coming last week. But they may have missed the fact that this may be good news. After a wild week of volatility, the S&P 500 has experienced a peak-to-trough 4.85% dip since the all-time high on May 21 (4.6% after Friday's modest rebound). We have noted in recent commentaries how unusually long the S&P 500 has gone without a 5% or more pullback. In fact, if the S&P 500 did avoid a 5% decline in the first half of this year, it would have been the first year in 16 to do so. Overdue for a dip, stocks found an excuse in last week's Federal Reserve (Fed) statement released on Wednesday (although China's weak economic data and financial turmoil that revived fears of a sharp slowdown also contributed to last week's decline).

In short, what market participants heard from the Fed — that the Fed is ready to soon end its bond-buying program — overwhelmed what the Fed said about how it plans to continue to expand its purchases at a slower pace.

Why Does It Matter?

The Fed seeks to manage financial conditions to keep unemployment and inflation low through "easing" (stimulus) and "tightening" (hindrance). Quantitative easing, or QE, is a process where a central bank stimulates economic activity by creating money and using this new money to purchase bonds from financial institutions. As a result of this bond-buying program, several positives can be highlighted:

- Commercial banks have seen a rise in their capital reserves, staving off the threat of insolvency and potential bank runs.
- Banks have more capital to lend (although they have not lent out much of their new reserves — limiting the effect of QE on the wider economy).
- The lessened risk of a financial meltdown helped boost stock market prices and encouraged risk taking and investment by businesses. Interest rates have come down — benefitting the housing market and borrowers at the expense of savers.
- The increased money supply has helped to prevent deflation — a downward move in prices that can pull wages and the economy down with it.

The benefits of QE have been widely touted by policymakers, and it is being implemented in various forms by central banks in economies around the world.

The stock market is very sensitive to what is seen as a program that — while not costless — acts as an insurance policy against a return of the financial

crisis that came to an end in 2009 during the first round of QE. The S&P 500 Index fell 10–20% following the end of the QE1 and QE2 bond-buying programs in 2010 and 2011. Stocks still remain somewhat sensitive to the end of QE, though there has been considerably more time and recovery in the economy, markets, and financial institutions since the time of the crisis.

What Was Said Versus What Was Heard

At a press conference shortly after noon on Wednesday, June 19, Fed Chairman Bernanke provided for the first time specific time frames for slowing and eventually stopping the bond-purchase program that, unlike previous programs, had no set duration or purchase amount. He emphasized that reducing the amount of purchases was not the same as selling bonds. He reiterated previous statements that the federal funds rate — the interest rate that is the Fed's primary tool for managing the economy and inflation — would not likely be raised before 2015. Perhaps most importantly, he also clarified that any action would be data-dependent and specified what economic data targets the Fed will want to see before it slows or stops the bond purchases. These included a goal of 7% unemployment rate (currently 7.6%) by the middle of next year.

In response, market participants were quick to sell, rather than welcome the transparency from the Fed and cheer for evidence of a self-sustaining recovery in the form of a further decline to 7% in the unemployment rate a year from now as the only way the bond buying by the Fed would come to an end. Market participants took what Bernanke said as a declaration of the nearing end of QE and engaged in a knee-jerk reaction of prices similar to what took place after the Fed ended the first two rounds of QE. In fact, stocks, bonds, and commodities all fell as markets started pricing in tightening (not due until 2015 at the earliest), not merely the potential end of easing. We can see this by looking back at the history of how stocks have reacted to the start of a period of tightening compared with the end of periods of easing.

While the Fed has been around for a long time (it was created 100 years ago), the Fed's communications on monetary policy have a much shorter history. In fact, it was really only in the 1990s when the Fed's actions became transparent to market participants [Figure 1].

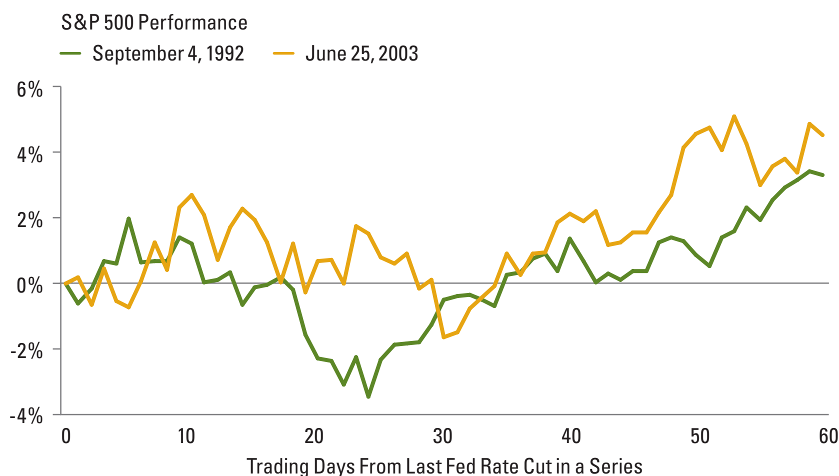
1 Fed Communication Milestones

1975	Presents testimony twice each year to Congress on the conduct of monetary policy.
1979	Releases the first semiannual economic projections.
1983	Publishes the first "Beige Book," which summarizes economic conditions in each Federal Reserve District.
1994	Begins to release a statement disclosing changes in the federal funds rate target.
2000	Begins releasing a statement after every meeting and starts to include an assessment of the balance of risks to achieving its objectives.
2002	Results of the vote are added to the post-meeting statement.
2004	Speeds up the release of its minutes: Now there is only a three-week lag, instead of waiting until after the next regularly scheduled meeting, which meant a lag of about six weeks.
2007	Decides to release its economic projections four times a year.
2011	Fed Chairman holds first post-meeting news conference.

Source: LPL Financial,Philadelphia Federal Reserve 06/24/13

Since the early 1990s, the Fed has ended a long period of stimulus on two occasions (a series of rate cuts): September 4, 1992 and June 25, 2003. Although there were some mixed signals that the Fed might end stimulus, lacking many of the communication tools the Fed uses today, the clearest communication came at the time of the last rate cut. In both cases, the performance of the S&P 500 Index flattened out in response but continued to move modestly higher with a gain of about 3–4% over the following three months.

2 Stocks Continued to Gain After the End of Fed Easing

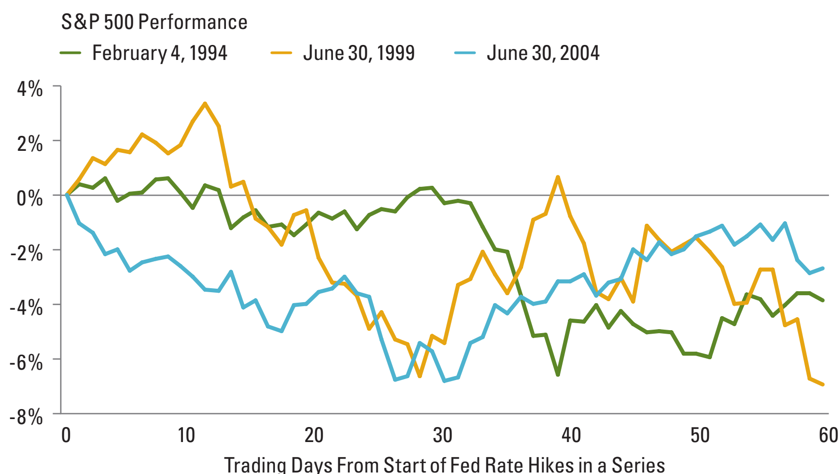


Source: LPL Financial, Bloomberg data 06/24/13

The S&P 500 is an unmanaged index, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. Past performance is no guarantee of future results.

Since the early 1990s, there have been three occasions when the Fed began a period of tightening (a sustained series of rate hikes): February 4, 1994, June 30, 1999, and June 30, 2004. The S&P 500 fell, though not dramatically, following these shifts by the Fed. In each case the S&P 500 Index fell 2–7% over the following three months. Signals for two of these moves came before the start of the rate hikes: May 18, 1999 and January 29, 2004. On both occasions, stocks fell over the week following the signal (-4% and -0.5%, respectively).

3 Stocks Fell After the Beginning of Fed Tightening



Source: LPL Financial, Bloomberg data 06/24/13

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Based on the history and what the Fed Chairman actually communicated, it appears the stock market started to move to price in the start of tightening rather than the potential end of stimulus.

What Happens Now?

The Fed's intention to stop or slow its bond-buying program later this year introduces the potential for greater volatility and makes a strong rally in the S&P 500 Index in the second half of the year similar to that seen in each of the past four years unlikely. We can expect further market volatility in the immediate period ahead until bond yields stabilize.

However, the knee-jerk reaction of selling across all markets — stocks, bonds, and commodities — is unlikely to persist for long. Only very briefly have we seen stock and bond prices move in the same direction in recent years. As we have all year, we continue to advocate buying the dips in the stock market for investors who are underweight stocks relative to their target weighting. Looking ahead, investors will focus on June jobs report due out next Friday (July 5); for clues as to how well the economy is tracking to the Fed's employment objective for ending QE. ■

IMPORTANT DISCLOSURES

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Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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