



July 1, 2013

Dear Clients and Friends,

We don't want to change. Every change is a menace to stability.
~ Aldous Huxley, *Brave New World*

Not much has changed since our last letter to you. And yet, much has changed.

To wit, the latest data suggest **the overall US economy is still muddling along the “slow and low” path** we’ve outlined over recent years. The housing market continues to recover from the mortgage crisis; the general employment picture has improved with weekly jobless claims trending ever lower; corporate profits remain at remarkably high levels; and interest rates – the other key element in securities valuation – are still well below historical norms. The problem spots are familiar too: troubled Greek debt is back in the headlines, and the Chinese economy is decelerating as their banks finally recognize they lent too much money to too many people who can’t repay their loans.

But the financial markets were in a tizzy at the end of last quarter, thanks in large part to Fed Chairman Ben Bernanke’s really bad metaphor: *“We’re going to be shifting the mix of our tools as we try to land the ship on, you know, in a smooth way onto the aircraft carrier.”* Bernanke was explaining to investors how the Fed planned to finish tapering down its \$85 billion per month in Treasury and mortgage bond purchases when unemployment reaches 6.5 percent. But the comparison of gradually tweaking the Fed’s Quantitative Easing (QE) program to trying to land on an aircraft carrier pricked up the market’s collective ears. The comment appears to have reminded investors that the Fed’s massive QE experiment runs the risk of inflation on one hand, and throwing the economy back into recession on the other.

This implied change in Fed policy – that it now acknowledges an eventual end to QE and may even start lifting its foot off the accelerator pedal as soon as this year – was the main driver behind the stock and bond markets’ extreme volatility in June. Indeed, **the knee-jerk reaction was global**, with emerging markets (like China) in particular reeling from the sudden recognition that cheap and easy money may soon be a thing of the past.

How quickly can we expect a significant change in interest rates? Not very, it seems, given the Fed’s official policy statements which suggest they are in no hurry to change their current programs. Bernanke has clearly stated such changes would be appropriate only if economic conditions improve as expected. The Fed likely wants to see signs of further economic stabilization, allowing investors to maintain confidence in corporate earnings despite the potential for moderately higher rates. The Fed did lower its 2013 GDP forecast following the onset of the fiscal budget sequester, but it remains optimistic for a resumption of growth – even an acceleration of growth – in 2014 and 2015. Even so, if the fear of change serves to destabilize the recovery’s underpinnings, QE could very well be extended. And given how quickly the Fed began backpedaling away from Bernanke’s miscommunication, we believe significant changes are unlikely in the near term.

Ultimately the markets do need to be weaned from the Fed’s easy money programs or risk creating new asset bubbles. But keep in mind that an end to QE does not mean the Fed will be raising its interest rate targets any time soon. We (and most of Wall Street) do not expect changes in the official Federal Funds rate before some time in 2014, if not 2015. So while you may have heard the financial press bemoaning the recent jump in interest rates, the 10-year US Treasury finished the quarter yielding 2.50%, still extraordinarily low by historical standards. And despite the stock market’s volatility, the S&P 500 index concluded the second quarter close to where the first quarter ended. As we said, not much has changed. And yet ...

Sincerely yours,

A handwritten signature in black ink, appearing to read "Mitch Schlesinger", with a long horizontal flourish extending to the right.

Mitch Schlesinger
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