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Market Notes—A Big Change In Fed Policy?

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A Change in Fed Policy?

Wednesday's Fed decision included a surprising change in their statement. Prior to this meeting the Fed had vowed to remain accommodative until "at least mid-2015". But the statement contained this interesting twist:

> **"In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. "**

Following the decision, the media was reading into the change in the statement quite a bit, but I believe the reason for the change in guidance is rather rational.

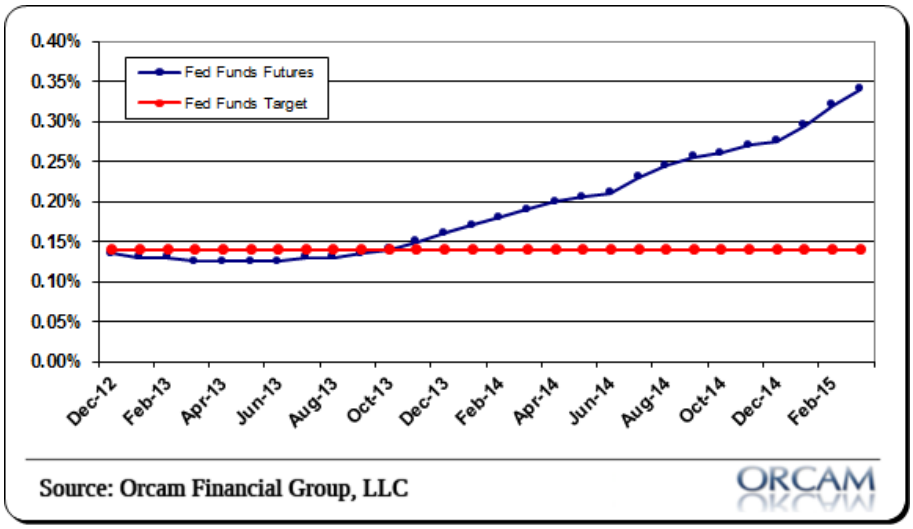
First of all, there is a high probability that Ben Bernanke will be leaving the Fed after 2013. In addition, there are growing signs of housing stability and potential for better economic conditions in 2013. This policy change provides the Fed with greater flexibility if there is a new FOMC Chief in 2014 and if there is a more dramatic economic recovery in 2013 than most presume. As is usually the case, the Fed is communicating its policy changes (if ever so marginal) well in advance. This provides breathing room.

(continued…)

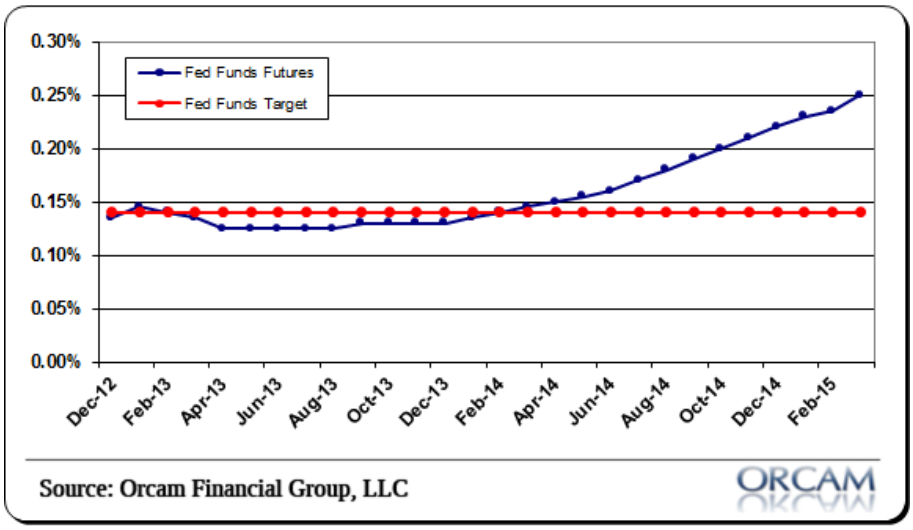
Long story short—The Risk/Reward Profile of the Market Takes a Turn for the Worse….

What Does This Mean For Government Bonds?

The view from the fixed income markets is a bit more interesting. Today's decision sent treasury yields spiking higher. But I still think this is noise around a much larger and more important trend. If we look at the Fed Funds Futures curve over the course of the last month we can see that the curve has continued to flatten. Although Wednesday's statement change increases the likelihood of a policy change before the "mid-2015" date, I don't think fixed income investors will begin pricing in a major rate increase until something more definitive is provided in the Fed outlook.



Fed Funds Futures Curve 11/15/12



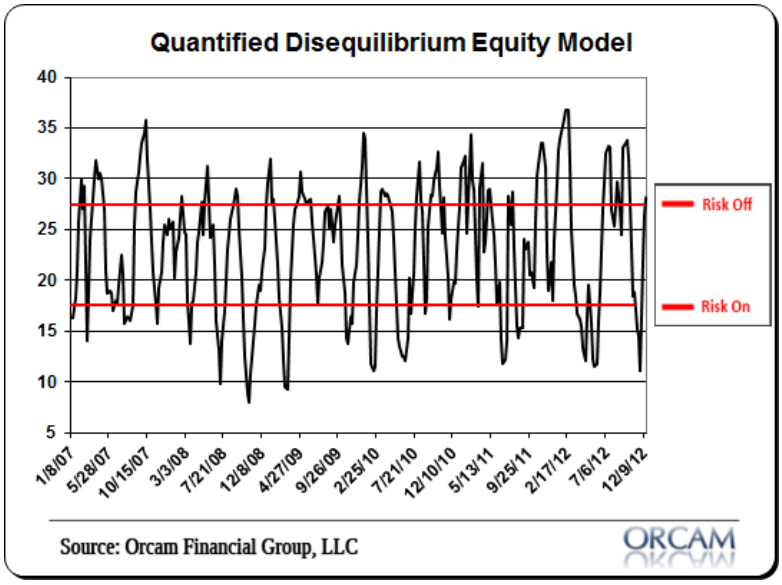
Fed Funds Futures Curve 12/12/12

It's important to note that we are still a long way from meeting the Fed's new targets. By my projections, we likely won't reach the Fed's 6.5% unemployment target until 2014 (currently 7.7%). So there is still a great deal of time lag here between the new targets and the potential time when a rate increase actually comes to fruition.

Based on this, I would expect the Fed Funds Curve to continue to flatten in the coming year and that will continue to put a floor under government bond prices. **The bull market in bonds is not over yet.**

Equity Market Overview

The outlook in the equity markets has become increasingly murky. Last month as the election was winding down and the fiscal cliff was causing substantial fear I repeatedly discussed the high likelihood of a year-end rally and the likelihood of a market reversal as uncertainty dissipated. The S&P 500 has rallied over 6% in the last month and the risk profile of the equity market has changed substantially.



As you can see at the right, Orcam's primary equity model has moved to a substantially less bullish position than we saw in early/mid November when the risk/reward had moved to a very favorable position.

Many readers have asked how best to use this indicator. I try to emphasize that while this indicator has proven to be extremely prescient at times I would never rely on any single indicator as a holy grail. **There are no holy grails in this business.** Instead, this is a piece of the puzzle that we have to consider inside of a more complex picture. I will certainly help you try to piece that puzzle together, but I'd be lying if I told you this (or anything else) was going to rain money down on your head.

The current reading of 28.5 is indicative of a market that remains bullish from a tactical phase, but not a market I would be adding to new positions in. As I said before, the risk/reward profile of the market has shifted to a substantially more negative position. I am by no means turning bearish before year-end, but unfortunately, if you've missed the recent 6%+ gain in the market you're now establishing positions that present a far less attractive trade.

From a strategic (longer-term) position I remain bullish. And while I remain a tactical (short-term) bull I would approach this market with substantially more caution than a few weeks ago. Hedging long positions or reducing long exposure is not an imprudent move at this juncture.

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