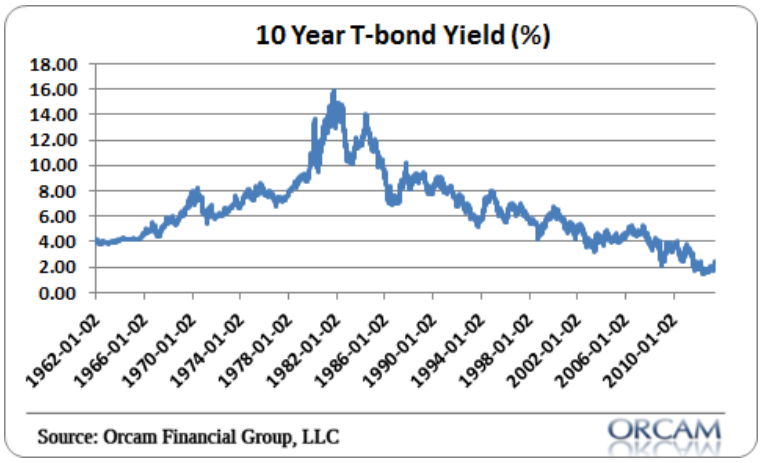
"Taper" Turns into Tantrum

Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

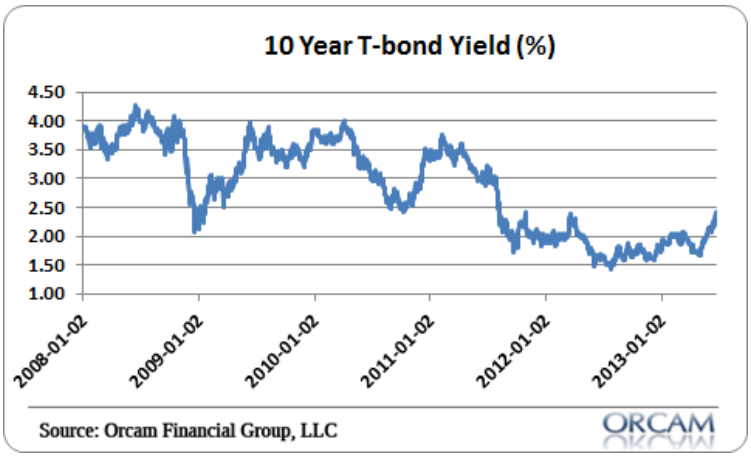
It looks like "taper" has turned into tantrum in the markets this week as bonds, equities and commodities have all fallen substantially following the FOMC meeting. The supposed cause of the declines is the rumored "tapering" of Fed bond purchases in the coming quarters. Obviously, QE has played an extremely important role in bolstering asset prices thus far, but should we really be seeing this sort of universal disgust for all asset prices? Let's explore.

First, let's take a long-term look at what's occurred in the last few weeks in the world of interest rates. A bit of perspective will help put the "surge" in yields in the right perspective. The recent move in the 10 year from 1.6% to 2.4% appears substantial at first glance, but in the grand scheme of things, has actually been min-

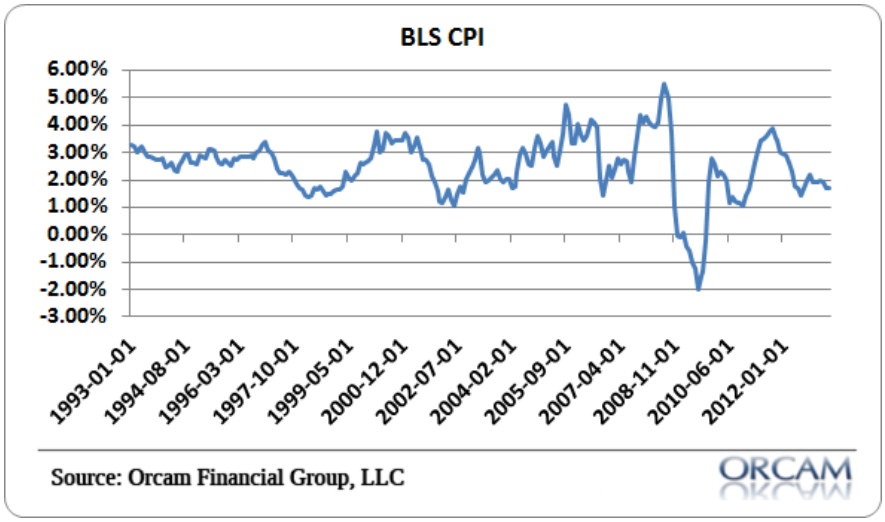


Less QE should mean less "money printing" which has resulted in reduced inflation expectations. So why in the world would bonds sell-off?

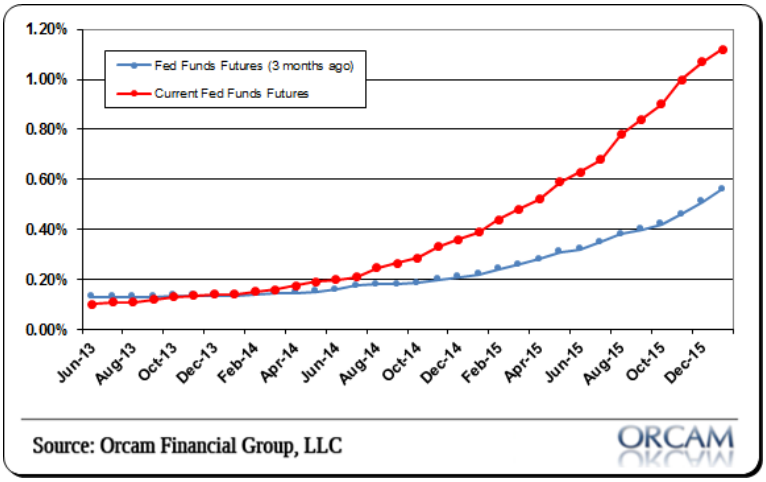
or. If we look at a 5 year chart the move looks just as benign. In fact, we're basically back to levels last seen in 2011. That doesn't change the fact that the 10 year bond price has fallen 4.5% since the beginning of May, but it should put some of the panicky discussion in the right perspective. This is not a substantial move in yields. And I don't expect it to turn into a substantial move in yields.



The reason is rather simple. **There is absolutely no inflation in the USA**. The chart below shows the long-term inflation trend in the USA. The current rate of 1.7% is extremely low. The bond market should become most concerned about future price declines if inflation rises. Now, this might occur for varying reasons. The more normal occurrence is a much stronger economy in which rates rise because the economy improves and the Fed ultimately tightens. The more abnormal case is a supply shock like we saw in the 70's. I don't think there's high probability of that occurring and the action in commodity prices in recent weeks certainly validates that. So then what about the Fed tightening? It might help to step back and better understand what QE is and why this tapering is being misunderstood by the markets at present.



QE involves open market operations in which the Fed simply swaps reserves/ deposits for outstanding Treasury Bonds or MBS. The private sector's net worth is the same before and after QE. The market doesn't view QE this way though. It's widely believed to be inflationary "money printing." So, let's assume



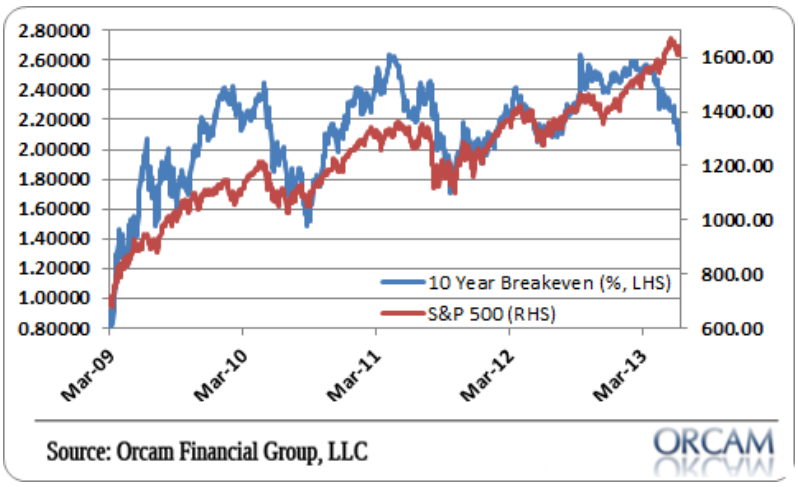
the Fed decides to begin the taper. That means the market will perceive this as **less** "money printing". That won't be inflationary at all from the market's perspective. So the debate about rates then becomes about the impact QE has already had on rates and why that impact might reverse itself. But I don't think QE has actually kept rates all that low to begin with. In fact, I think the primary reason rates are low is because the Fed has continued to maintain a zero interest rate policy during a period when inflation has remained abnormally low. In other words, QE or no QE, rates would have been low either way. In addition, the switch from $85B to $65B per month in bond purchases should only mean less "money printing" from the market's perspective. Again, that is not a dramatic change in policy even if it hints at the beginning of a rising rate cycle.

But most importantly, I think the market is just flat out wrong about the potential for a future rate hike. The chart above shows the Fed Funds Futures curve from 3 months ago compared to the current curve. The December 2015 contract has surged from 0.55% to 1.15%. That means the market is pricing in more than THREE rate hikes between now and 2015. That's an enormous change in views from just 3 months prior. And in my opinion, it's a substantial overreaction. The bond market has essentially taken a $20B per month reduction in QE to equal a 1% rise in the Fed Funds Rate. But we should be very clear. The Fed is only tapering QE for now and will not likely begin tinkering with the Fed Funds Rate for several years if not longer. The economy is simply too weak to justify that sort of an advance in the rate tightening cycle. So this looks like a bit of an overreaction in bonds to me.

The bottom line is that QE could have negative psychological impacts on many asset classes, but bonds are not an asset class that should see sustained negative effects from tapering. After all, when the market settles down and realizes that they can now earn a positive real return in US Treasuries compared to the uncertain outlook for gold, equities and commodities then the world's safest risk-free asset will start to look pretty attractive. And given the economic weakness and low inflation data I think we're much more likely to see 2% on the 10 year before we see 3%.

As for other classes—well, I can't say that I am as confident that they're overreacting. I think bonds have acted quite rationally over the last few years. In a world of low inflation and zero interest rates it's entirely rational for the 10 year yield to trade just above the rate of inflation. So we shouldn't be at all surprised by the continually low bond yields and we should expect that to continue since the economy is likely to remain weak and inflation likely to remain low. The same cannot be said for

equities, which seem to suffer from certain mythical beliefs regarding QE. The chart to the right shows how the psychological change in inflation expectations has shifted with the S&P 500. In a market environment where inflation expectations are cratering it would be rational for government bonds to become a safe haven. Stocks, on the other hand, could be susceptible to further downside.



Orcam Financial Group, LLC

Orcam Financial Group, LLC is a fee only financial services firm offering macro research, personal advisory, institutional consulting and educational services.

Important Disclaimer

ORCAM