



## The Taper is Here—Now What?

### The Taper—a Strategic Non-event

Today the Federal Reserve announced that they will begin tapering back QE by \$10B per month starting in January. That means they will trim their total monthly purchases of MBS and Treasury Bonds by \$5B each to a total combined value of \$75B. This might imply the beginning of a long-term “tapering” cycle, but does that mean we should view this as a tightening cycle? And more importantly, should we view this as a negative economic and market event? I say no.

First of all, when we view the tapering we have to look at the dynamics behind what’s really going on and how impactful this will actually be. Quantitative Easing, at its most basic level, is a simple asset swap that changes the composition of private sector assets, but does not necessarily increase the amount of financial assets the private sector holds. QE does, however, force a portfolio rebalancing effect which can substantially increase the supply and demand for particular asset classes. Additionally, QE sends powerful psychological messages to market participants about how much risk they should be willing to take. Some of these dynamics are quite powerful while others are vastly overstated by market participants.

When we put this into the framework of understanding QE and the tapering we have to maintain some perspective here. Over the course of the last 12 months the Fed has been buying \$85B in MBS and T-bonds. The change from \$85B to \$75B is not insignificant, but I would hardly call this “tightening. For instance, if we just put this in

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**Cullen O. Roche**

Founder

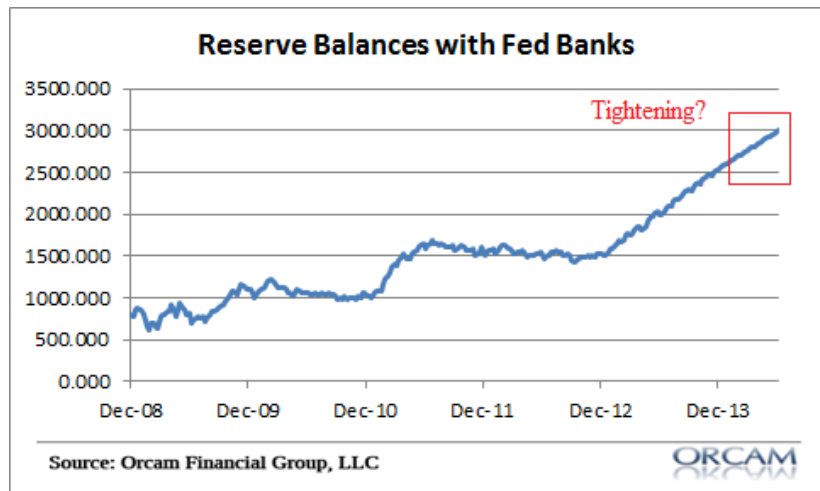
Orcam Financial Group, LLC

[cullenroche@orcamgroup.com](mailto:cullenroche@orcamgroup.com)

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**The Taper Should not Impact our Cyclical Outlook Much.**

perspective we can begin to see just how meaningful (less) this move is. If we project this change in balance sheet size out over the course of the next 6 months you can see just how little the actual balance sheet trajectory changes in the figure to the right. “Tapering” is not tightening. “Tapering” is just QE of a lesser magnitude. And in this case, the \$10B is a fairly minor policy change.

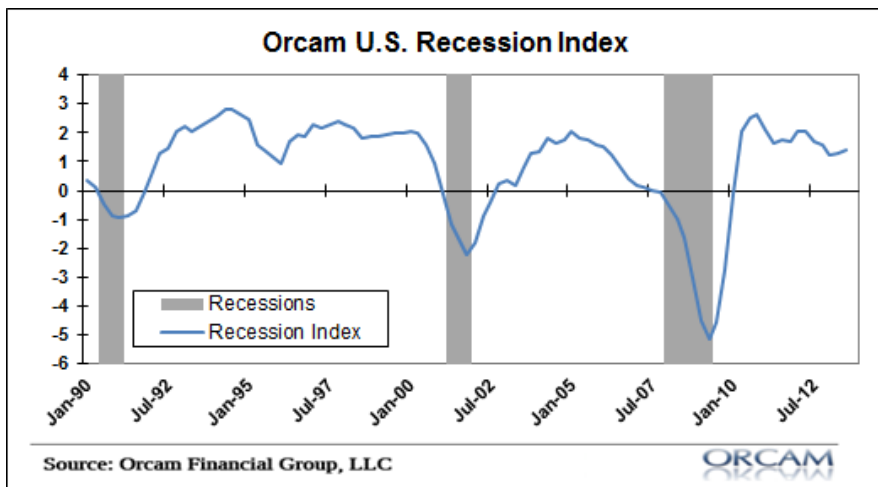


Of course, it could be a prelude to larger balance sheet changes. And in fact, if the economy improves as I think it will in 2014 then that means we could begin to see meaningful changes here. But the Fed won't pull the punch bowl away all at once. They've been abundantly clear that they will maintain their zero interest rate policy even while the tapering is occurring. So, in my opinion, the most powerful policy tool (interest rate changes) remains extremely accommodative and is likely to remain so.

This is particularly important for the strategic or cyclical view of the market. I would not allow QE to become too much of a distraction to our long-term outlook on the markets. It's my perception that the market is responding to the potential tapering with a rather levelheaded response. Today's big rally in stocks was a clear sign that the market can handle a bit of tapering and understands that the Fed isn't going to pull the punch bowl away all at once.

So, from a strategic perspective I would remain entirely data dependent. And the data still looks positive. There are little to no signs of recession on the horizon and that means that the probability of a tail risk event are low.

Our most important strategic indicator, the Orcam Recession Index has strengthened modestly in recent weeks and is still consistent with a modestly growing economy. Most importantly, it is not flashing signs of recession as it has before each of the last few recessions when major tail risk events occurred.



This is all good news. Tapering is beginning to be seen as a sign that the economy is healing. Most importantly, it is not being seen as a sign that the Fed is going to crash the party.

In sum, I would continue to view tapering and other Fed moves as non-events from our strategic longer-term perspective.

We will continue to closely monitor the economy and the potential risks to the strategic outlook, but for now, QE and tapering is not a big concern on that front.

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