

We were expecting the U.S. Federal Reserve Board (the “Fed”) to begin to taper its asset purchases at its most recent meeting. In June, the financial markets reacted quite violently to Mr. Bernanke’s press conference that first suggested that “tapering” may soon begin. However, over the past three months, the markets seemed to have adjusted and priced-in that reality. In so doing it appeared to give the Fed a “free pass” to start the process of reducing the growth of its very large balance sheet. There are several possible explanations why it didn’t:

1. The Fed did not feel recent economic reports were strong enough – we do not espouse this view as the economy, while not vibrant, has continued to grow.
2. The Fed was concerned that the power struggles within the U.S. Government would further weaken fiscal policy and the economy – while true; actually shutting the monetary spigots might force Congress to face reality.
3. The jarring reaction of financial market to the tapering idea, particularly the increase in longer term Treasury bond rates, misinterpreted the Fed and threatened economic growth – this is our best guess as the main factor. Unfortunately if that is the case, we perceive some consequences. The Fed loses some credibility and promotes uncertainty when it flip flops; Bernanke’s protest that the Fed doesn’t worry about market reaction sounds weak; and perhaps most importantly suggests that each time the Fed attempts to tighten policy a negative market move could make it back off. Nonetheless, whatever the reason (and we have only suggested three) continued easy monetary policy is good for stock markets.

We listed in our last commentary some of the pressing issues needing resolution in the U.S. Congress. The intra-party divisions amongst Republicans have been well documented as the so called “tea party” faction has not followed the party leadership. Now the Democrats are in a similar position, since members of Obama’s own party were prepared to vote against attacking Syria and against his candidate of choice for Fed Chairman, Larry Summers. Such divisiveness is historically rare and will make upcoming policy solutions even more difficult to attain. Compromise is at the heart of successful government and there isn’t much of it in Washington. We have often been critical of the legislative and executive branches of the U.S. Government, but recent “horse trading” of votes has, in our mind, reached a new low. The notion that someone would agree to vote to bomb Syria in exchange for a vote on the budget or the healthcare act is unseemly at best, but reflects the current reality.

We continue to prefer the U.S. economy and markets over Canada. Canada continues to depend to a meaningful degree on its resource based industries. Emerging markets, in particular China, were in large part responsible for the demand that drove commodity prices higher. With China trying to reign in its rate of growth, and countries like Brazil and India slumping, many commodity prices are significantly lower. While the recent move by the U.S. Fed has ameliorated the decline in the short term, we believe the direction will remain to the downside with negative consequences for the Canadian economy. The American economy, on the other hand, benefits at the margin due to a cheaper cost of goods.

“This too shall pass” are words to live by in the current market environment as markets thrash about with every utterance from Washington, Moscow, Berlin, Tokyo, etc. The bottom line is that the U.S. economy continues to grow, monetary policy remains very accommodating, and the S&P Index shows few signs of weakness. So far, the fat lady remains in rehearsal.