<u>Outlook for November, 2013: "Policy Myopia…"</u>

US equity markets continue to rejoice – with the S&P500 hitting all-time highs recently – on the Federal Reserve's largesse. While corporate earnings releases for 3Q2013 are coming in ahead of expectations, the market appears to be anticipating continued support from the Fed. Policy actions by the Fed as well as those by Congress and the Administration appear to be ***increasingly myopic – focusing on the short term*** rather than the longer term.

Of all the data points the Fed looks to in their monthly FOMC meetings, none are as important in the markets' minds as employment. The Fed has a dual mandate: to achieve ***maximum*** employment and maintain stable prices. Unfortunately, we feel that Bernanke and his likely successor, Janet Yellen, have placed too much emphasis on the former without taking into account the costs and benefits of their policy actions.

The October establishment survey reported a gain of ***204,000 jobs*** for the month, handily beating expectations of 120k. Revisions to the prior two months showed a positive gain of 60k additional jobs. The private sector accounted for 212k of the increase while government declined by 8k. Within the private sector, professional and technical services added +21k, leisure and hospitality +53k, retail trade +44k, and manufacturing +19k. As we've alluded to before, most of the jobs being created appear to be ***part-time, temporary positions***. We are not seeing the types of high quality, high earning positions that are typical of a robust dyed-in-the-wool U.S. recovery.

On the other side of the employment report, the Household survey showed a small increase in the unemployment rate from 7.2% to 7.3%. To put this in perspective, 7.3% represents approximately 11.3 million unemployed persons. Of that number, 4.1 million are considered long-term unemployed (defined as jobless for at least 27 weeks). The labor force participation rate fell to a forty year low at 62.8% and the ***U-6 measure*** of unemployment rose two-tenths to ***13.8%.***

Real GDP grew at an annualized 2.8% in the third quarter, compared to 2.5% in the second quarter. Personal consumption expenditures, state and local government spending, housing, and consumer durables added to growth while imports and federal government spending detracted. Since the recovery began in mid-2009, real GDP has trended well below the economy's potential GDP and clearly this ***recovery*** has been ***anemic*** at best.

While Quantitative Easing (QE) was begun as an ***emergency measure*** by the Fed to reduce borrowing costs for businesses and firms way back in 2008 (at the nadir of the financial crisis), the current version appears to be taking on the characteristics of a more ***permanent program.*** And therein lies the rub. The Federal Reserve continues to add to its stock of holdings of US Treasury Notes and mortgage paper at a steady clip of $85.0 billion per month with apparently no end in sight.

Indeed, since late 2008, the Fed has through successive rounds of QE almost ***quadrupled*** the size of its balance sheet to $3.85 Trillion. The Fed essentially bought more than 100% (no that is not a typographical error!) of ***net new issuance*** by the US Treasury in the past twelve months and its ***"non-tapering"*** at the September FOMC meeting has set off the animal spirits in all sorts of risk-on markets.

One argument in favor of the Fed's moves has been the ***moribund nature of fiscal policy.*** In other words, with fiscal policy clearly impotent, it was up to the Fed to shoulder the entire burden of reviving the economy and ensuring that growth returns to its halcyon days in the US. This is a specious argument since the Fed's job is primarily centered on its ability to maintain low inflation. While Congress has also added on the attainment of "full-employment" to that mandate (since 1977) as well as financial stability to its role (since 2010), we now have a classic ***"mission creep".***

Even the definition of ***"full-employment"*** is a moving target; Wikipedia suggests "it is defined by the majority of mainstream economists as being an ***acceptable*** level of unemployment somewhere above 0%". Despite all the hemming and hawing, we appear to be very rapidly approaching diminishing marginal returns from QE and the question remains "how is the Fed going to reduce the size of its balance sheet when the time comes for it to do so?"

The ***policy myopia*** clearly applies to the fiscal side as well: Congress and the Administration have continued to spar over taxes, spending and the debt ceiling over the past few years – lurching like drunken sailor from one crisis to the next!. This has resulted in a quagmire of tax policy and regulations. In classic political fashion, Congress and the Administration agreed to ***"extend"*** the debt ceiling from Mid-October to Mid-February ***(talk about lack of long term thinking!)*** after enduring a partial shut-down of the Federal Government for a little over two weeks.

Farther afield, the European Central Bank lowered its benchmark interest rate by 25bp in a surprise move in response to "greater downside risks to growth" in the words of ***Mario ("whatever it takes") Draghi.*** The Bank of England has also implied that future monetary policy actions will likely be ***"data dependent"*** – taking a page from the Fed's play book.

The ***People's Bank of China***, that country's central bank, has also resorted to adjusting money market rates based on changing economic conditions – especially after their actions engendered much confusion in late June. Further, ***Raghu Rajan***, a respected academician and current Governor of the ***Reserve Bank of India*** has made much of the country's monetary policy deliberations to coin a phrase "data dependent!"

This ***obsession*** with a short term focus on policy does not augur well for the long term. If anything it ***increases uncertainty and condemns economies*** to a slower pace of growth. Businesses are loath to plan for the long term – particularly with regard to plant and equipment, mining or even hiring decisions – since neither monetary nor fiscal policy provides any stability for managers and entrepreneurs to think longer term. This is a ***dangerous trend in policy making*** which we believe runs the risk of negatively impacting the longer term potential growth rate of even healthy economies.

A word about 3Q2013 earnings: With 451 companies in the ***S&P500*** having reported earnings so far (90% of the entire index), 334 (or 74% of those reporting) have shown an increase in earnings relative to the same quarter last year, 102 (or 23%) have reported a decline in earnings and the rest 15 companies (or 3%) have had the same level of earnings. ***Relative to expectations***, 306 (or 67.8% of those reporting) have exceeded expectations, 56 (or 12.4%) have met expectations and 89 (or 19.7%) have failed to meet expectations.

All in all, the share weighted percent gain in earnings (in aggregate) is at 5.0% - slightly better than the run-rate for 3Q2012 (at 4.6%) and certainly better than the picture in 2Q2013 (at 3.8%). This is also the first quarter where there appears to be ***genuine "top-line" growth*** in company revenues – a hopeful sign that perhaps economic growth is indeed picking up.

In summary, equity markets continue to ***"make hay while the sun shines"***. Your portfolios remain fully invested, but we are worried that policy making in both the US as well as the rest of the world has becoming ***unusually myopic*** – focusing on the short term to the detriment of the longer term. As always, our abiding faith in a ***fully diversified portfolio*** - that has a balanced approach to both risk and return - as the main way to attain ***favorable investment outcomes*** over the long haul remains steadfast.

We would like to wish our regular readers a Happy Thanksgiving!

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