<u>Outlook for September, 2013: "Politics at the Federal Reserve?"…</u>

US equity markets continue to ***rejoice*** – on news that the Federal Reserve chose not to ***"taper"*** its ongoing program of Quantitative Easing (QE) at its recently concluded FOMC meeting. While "Uncle Ben knows best" is a well-regarded phrase among financial market participants, this time however, politics might be raising its ugly head at the Fed, thus damaging its ***credibility*** over the longer term.

The Federal Reserve does have a ***credibility issue***: Market participants had been overly focused on the Fed's move ever since Uncle Ben uttered the "taper" word at a press conference earlier this spring in May. From a longer term standpoint, the FOMC did lower their growth expectations for the rest of 2013 as well as for 2014 and 2015 and left QE unchanged as they felt that they needed to see "more evidence" of the economy on a solid footing.

We have felt that the timing of the "tapering" had more to do with the exit of Bernanke from the Federal Reserve rather than the economy doing better. Lost in translation is the idea that the very concept of QE is an ***emergency measure.*** With the economy now seemingly on a reasonable footing and forward expectations for growth strengthening (despite the Fed's latest downbeat assessment), we suspect that tapering is probably nonetheless not that far off.

Having said that however, we do believe that an actual ***tightening*** of monetary policy (by increasing administered rates) is at least more than a couple of quarters away. We do believe that market participants had been afraid of a "tightening" of monetary conditions as a result of the "taper", but we remain convinced that easy monetary policy appears to be the Fed's ***modus operandi*** for the foreseeable future.

From a data standpoint, the US economy continues to grow in fits and starts: The ***labor market*** posted an increase of 169,000 jobs in August, but coupled with downward revisions to the figures for July (-58k) and June (-16k), this report appeared to suggest some loss of momentum. Measures of hours worked and average earnings showed modest improvement.

The labor market report also contained news that the ***labor force participation rate*** hit a cyclical low at 63.2% - suggesting that the process of healing while ongoing appears to occur in fits and starts. The unemployment rate declined one-tenths to 7.3% for the month. The broader measure of unemployment, also known as the U-6 measure (which takes into account discouraged workers as well as those working part-time for economic reasons alone) posted a decline of three-tenths to a still high 13.7%.

Forward looking survey data including those put together by the Institute of Supply Management appear to indicate ***"steady improvement"***. The ISM manufacturing index rose 0.3 to 55.7 during August. The ISM Non-Manufacturing Composite (a similar measure of activity for the service sector) posted a nice gain of 2.6 points to 58.6 for the month of August. Consumer Confidence also rose slightly to 81.5 from 81.0 in July.

Inflation readings remain subdued and benign: Producer prices for finished goods rose a mere 1.4% (year-on-year) during the twelve months ended August while consumer prices for finished goods also rose a mere 1.5% (year-on-year) for the same period. The more ***"technically sound"*** ex-food and energy measure gained a still subdued 1.8% (year-on-year) for the same twelve months. In other words, ***rising inflation*** does not appear to be an imminent problem for US policy makers at this juncture.

More than the Federal Reserve's "we did not mean that" approach to monetary policy making, markets might be in for a rude awakening as a result of the ***budget battles*** in Washington DC later this month.

The threat of a shutdown of the Federal Government appears to have been taken into consideration by the FOMC when they decided to "stand pat" last week.

The budget shenanigans coming out of Washington DC are, to coin a phrase ***"epic"***: Democrats in the Senate (that August body that has not passed a full budget in over four years!) believe that they are the bulwark against Republican activism coming from the House of Representatives. Republicans in the house in turn believe that it is their turn to "save the nation" from the ravages of further wasteful spending and a takeover of large swathes of the economy by the Federal Government (aka Obamacare). Indeed, the House recently passed a resolution to repeal the Affordable Care Act a record forty-second time!

A shut down of the Federal Government will likely not have much of an impact on our daily lives, but a threatened ***"default"*** on US debt – since the Administration ***"refuses to negotiate"*** on the debt ceiling - might end up being the bigger of the two issues. There is no question in our mind that volatility is likely to increase as a result of these uncertainties. The daily average standard deviation (a measure of expected price movement each trading day) over the past ninety days has fallen to an unusually low 0.65%. As a frame of reference this same measure was a little north of 4.0% in October, 2008.

Municipal credit markets appear to be seeing some calm this month after a tumultuous summer! This summer brought news of a bankruptcy filing by the City of Detroit as well as widespread reports of credit concerns regarding the Commonwealth of Puerto Rico. Detroit is a classic case of governments promising too much with no ability to keep those same promises. Puerto Rico is also a similar case of having too much of a good thing.

We do feel that while print and television media do tend to dramatize the problems with municipal issuers, there are over 54,000 (***yes, fifty four thousand***) ***individual issuers*** in the municipal credit markets not all of whom are "bad credits". In other words, in classic fashion, markets appear to have "thrown the baby out with the bath water" yet again, and we feel that a judicious admixture of municipal credits does diversify the fixed income side of a portfolio.

Farther afield, ***GDP in Japan*** was pegged to have grown by 3.8% (quarter-on-quarter, seasonally adjusted annual rate), with both consumer as well as business spending leading the charge. Japanese policy makers (Prime Minister Abe among them) do have an opportunity to finally cut through the ***shackles*** that have made most external observers worry about the ***comatose state of affairs*** there. If used appropriately, the Yen's recent weakening could promulgate many years of "above trend growth" provided they pursue true opening up of Japanese markets.

Angela Merkel of the Christian Democratic Union – in many ways one of the key architects of ***European policy*** going forward – appeared to win another term of office in closely watched elections in Germany. However, her party did not win enough seats in Parliament to be able to go it alone. She will therefore have to cajole recalcitrant opposition parties to join her governing coalition – something that she seems to have a keen eye for!

In summary, equity markets continue to rejoice at the prospect of further largesse from excess global central bank liquidity. While your portfolios remain fully invested***,*** we are worried about near term volatility engendered by policy uncertainty in the US. 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 apologize for the delay in publishing this month's commentary: It was entirely Katy Blackman's fault, as she decided to give birth to Charlotte Lynn earlier this month! Both mother and baby are doing fine and we at MBR Financial are pleased as punch.

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