CAPITAL ADVISORS INCORPORATED

RESEARCH UPDATE

September 16, 2013 **Market Comment**

If the consensus opinion of economists is correct, the Federal Open Market Committee (the "Fed") will begin to "taper" monetary policy this week. More precisely, on Wednesday afternoon the Fed is expected to announce its plan for unwinding a policy tool known as quantitative easing, or "QE," which involves the purchase of $85 billion per month in Treasury Notes and mortgage-backed bonds. Investors seem to expect a $10-$15 billion reduction in the pace of monthly bond purchases by the Fed.

Beware of alarmist forecasts in the media about Fed tapering. For example, it would be accurate to say that *throughout the entire history of the United States, stocks have always dropped, and bonds have always rallied, when the Fed has terminated a QE program.* Unfortunately, the sample size for this declaration is two, so it probably means nothing. Also, there is an important difference between the current QE program and the previous two. With the first two programs, the Fed announced the termination date in advance, and bond purchases stopped completely when the program expired. There was never room for uncertainty about the duration of the previous QE programs.

In contrast, QE3 was launched without a pre-determined stopping point. This difference is important, because it enabled a much wider range of expectations among market participants compared to the previous two. This in turn led to a wider range of investment strategies in reaction to QE3 relative to the previous examples.

In May, when the Fed first hinted about its intention to taper QE3, investors who expected a longer duration for the program needed to recalibrate their assumptions. Stocks wobbled and interest rates spiked as portfolios shifted toward a narrower consensus enabled by the new guidance from the Fed

As we approach the Fed's big announcement on Wednesday, it is important to note that financial markets have had three months to adjust to what the Fed seems likely to say. While investors will certainly react to the details of the Fed's plan, we suspect the behavior of financial markets will feel like a yawn relative to the media hype likely to surround the event.

We are much more concerned about future developments in four areas – inflation, China, Japan and the euro zone. Here is a quick update on each:

Inflation: In order for the Fed to unwind QE3 smoothly, it must execute the withdrawal process on its own terms. Rising inflation would threaten its ability to do so. Recent news on this front has been favorable. There has been no sign of problematic inflationary pressures in the recent data.

China: Credit markets in China locked up in June, while economic data showed a marked slowdown in the pace of growth. More recent data from China has been better, and the credit markets seems to be functioning smoothly again. Analysts debate the sustainability of China's recent recovery, and we tend to side with the skeptics. For now, however, conditions in China are improving.

Japan: Japan is a major risk factor for the global economy because it has the highest ratio of government debt-to-GDP of any nation in the developed world. Some refer to Japan as "a bug in search of a windshield." Japanese policy makers are addressing the situation with aggressive fiscal programs, monetary stimulus, and legal/regulatory reforms. The behavior of Japan's financial markets should offer clues about the direction of their progress. Like China, recent signals from Japan have been encouraging. The Japanese stock market is up over 7% in the past three months, and over 20% thus far in 2013. The Japanese currency and credit markets have also been stable.

Euro Zone: We are also watching the behavior of financial markets in Europe for clues about the progress of reform. European equity markets outperformed domestic equities in August, and money flows into European mutual funds and ETFs have turned positive for the first time since the financial crisis. Structural problems in the euro zone are far from solved, but like the three risk factors listed above, recent news has been favorable, suggesting conditions are evolving in a positive direction…for now.