MARKET Commentary

Taper, Taper, Toil and Trouble

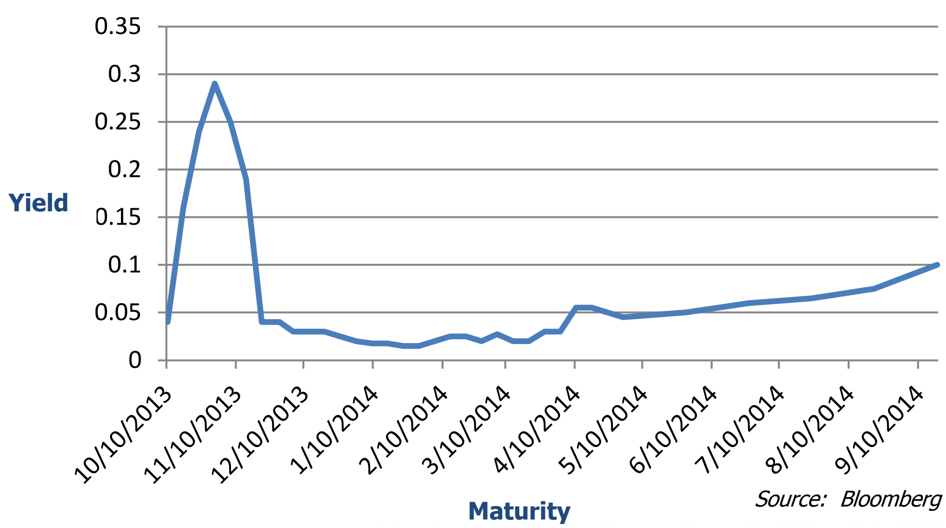
October 2013

The conclusion to 2013 is shaping up to be an entertaining, market-moving one. It won't likely eclipse the cataclysmic close to 2011 when the demise of the European Union seemed imminent. It will, however, be dominated by Fed policy and political gamesmanship over the budget and, more importantly, raising the debt ceiling. The Fed will continue to look at incoming data to determine when tapering will begin. Our expectation is tapering might commence at the December meeting, but will more likely occur next year. On the political front, brinksmanship will introduce volatility until a last minute deal is reached. The odds of a technical default are rising, but it is still a very low probability event in our estimation.

Fiscal Madness

The fourth quarter opened with a government shutdown as Congress could not cobble together a budget by the September 30th deadline. Republicans want concessions on deficit reduction and the Affordable Care Act while Democrats will discuss longer-term budget concessions only after the government is reopened and the debt ceiling is increased. Expect further political posturing and wrangling to come. While the uncertainty around the budget is not constructive for markets and may subtract modestly from GDP, it is not a significant risk to investors. However, ensuring that the debt ceiling is raised allowing the government to continue to borrow and fund itself is extremely important. Treasury Secretary Lew has stated that the U.S. will exhaust its borrowing capacity on October 17th while the Congressional Budget Office estimates the ceiling will be hit between October 22nd and October 31st. Short Treasury yields are pricing in this uncertainty with yields peaking on the October 31st maturity at 29 bps (see Figure 1) from low single digits one week ago. If the 2011 debt ceiling debacle serves as a blueprint, yields will rise another 15 bps or so on short maturities as the risk for a technical default rises.

Figure 1: U.S. Treasury Bill Yields (as of October 8th)



Source: Bloomberg

US Treasuries

As of 30-Sept

Benchmark	Yield
3 Month	0.01%
6 Month	0.03%
1 Year	0.09%
2 Year	0.32%
5 Year	1.38%
10 Year	2.61%
30 Year	3.69%

Bank of America/Merrill Lynch Indexes

30-Aug to 30-Sept

Index	Return
1-3 Yr Gov/Corp ≥ A	0.25%
1-3 Yr Municipals	0.20%
1-3 Yr Agencies	0.20%
0-3 Month UST	0.00%
S&P 500	3.14%

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Source: British Bankers' Association, Federal Reserve, US Treasury, Bloomberg, Barclays, BofA/ML, S&P and Wall Street Journal

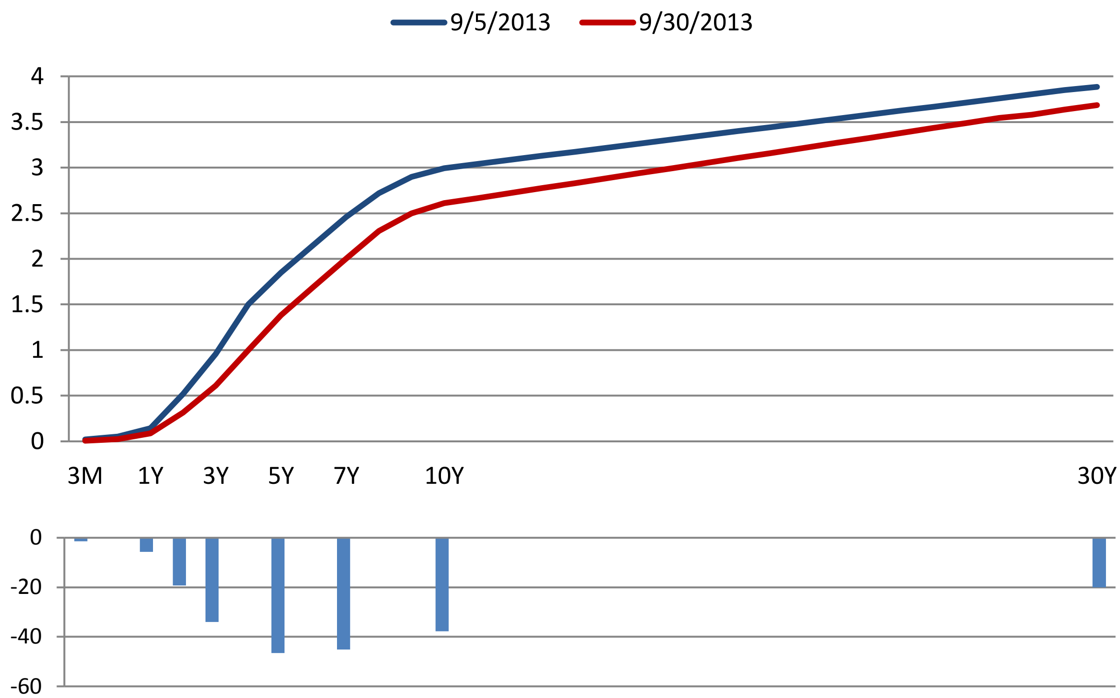
Additionally, during the last debt ceiling showdown in August 2011, money funds experienced significant outflows. According to the ICI, U.S. Government money funds lost almost 8% of total assets and prime funds experienced outflows of just over 4% of assets.

The debt ceiling debate bears close monitoring and risk-averse investors should be aware of how much "risk-free" Treasury exposure they hold maturing in late October and early November. Investors that can hold risk should look to add exposure to short T-bills as yields approach levels that would require extending to April of 2015 for the equivalent yield of a 2-3 week T-bill. Should the political situation deteriorate, a technical default would be highly disruptive to global markets. While we do not expect it to get that far, this is politics so the situation is fluid.

To Ease or Not to Ease

The recent announcement of no reduction in bond buying or "tapering" by the Federal Open Market Committee (FOMC) caught many market participants by surprise. Bond yields that had priced in less accommodative policy immediately declined (see Figure 2), especially in the belly of the curve (5-10 year maturities), after peaking in early September. Market expectations for the first rate hike were pushed out to mid-2015 from late 2014.

Figure 2: U.S. Treasury Yield Curve



Source: Bloomberg

The FOMC cited tightening financial conditions and fiscal headwinds as sources of concern. It further reiterated that the monthly purchase program is data dependent and not on a preset course. It also emphasized that the 6.5% unemployment rate is a threshold, not a trigger. In the revised Fed projections, the bulk of the FOMC expects the first rate hike in 2015 even as most project the unemployment rate to hit 6.5% next year. Markets are having difficulty interpreting the Fed's forward guidance and data-dependent focus. Given what has transpired thus far in October, it's difficult to see how the Fed pulls back on quantitative easing at their late October meeting, which pushes any decision to mid-December or later. The FOMC does not meet in November.

Monetary policy will not substantially deviate from the status quo in the near-term. The recent nomination of Vice Chairwoman Janet Yellen to Fed Chairman assures accommodative policy continuity when Bernanke steps down on January 31, 2014. Yields will fluctuate as economic data is reported and the markets price in expectations of Fed action. However, the Fed will be reluctant to change policy until the economy shows continued improvement which translates into a stronger labor market (not solely measured by a decline in the unemployment rate). The Fed funds rate will remain low for some time, likely longer than many would expect. This will keeps yields on securities maturing inside two years range-bound over the next 18 months.

Money Market Regulatory Update

The Securities and Exchange Commission (SEC) proposed money fund regulations in June to address money market fund runs, increase transparency and hopefully prevent another Reserve Primary Fund debacle (requiring a government guarantee across the industry). The comment period closed in September and a final rule is expected around the end of the year. Implementation of the final rule will likely take one to two years. The proposals are summarized below:

- *Floating Net Asset Value (NAV)* – Prime institutional, including tax-exempt, money market funds would be required to transact at a floating, market-based net asset value rather than maintain a $1.00 stable share price.
- *Redemption Limits* – Money market funds would continue to transact at a stable share price but would use liquidity fees (a 2% fee on redemptions) or redemption gates (a temporary suspension of redemptions) when a fund's liquidity falls below a certain level.
- The SEC could adopt either alternative or a combination of the two.
- The SEC also proposed additional diversification and disclosure measures.
- Retail funds (currently defined as a fund that allows investors to withdraw no more than $1 million at a time) and Treasury-only funds would be exempt from these regulatory changes.

The money fund industry has vociferously opposed further regulation while prominent regulators, including the Financial Stability Oversight Council (FSOC) and the Federal Reserve, have been calling for further action for some time. In 2010, the SEC adopted new rules that tightened portfolio rules, but did not address structural vulnerabilities that leave money funds susceptible to runs. These new rules are expected to address those shortcomings.

Looking Forward

Fiscal policy uncertainties posed by political brinksmanship on the debt ceiling and budget negotiations must be monitored closely. We expect political wrangling right up to the last moment which will unsettle markets. Be cognizant of the short U.S. Treasury exposure in your portfolios and be prepared for the possibility of a large move out of money funds. Monetary policy should continue in its current form through year-end. Look for an improvement in economic data as well as broad-based strength in employment (unemployment rate, labor force participation rate, non-farm private hours, etc.) as cues for a reduction in quantitative easing. Fed funds will remain low for at least another year which will anchor short rates requiring investors to look to high quality spread product (like high-grade credit and AAA asset-backed securities) for attractive opportunities. Finally, money fund regulation is coming. Look for the SEC to release its final rule (likely the floating NAV alternative) later this year, but implementation is still a year or two away. All of these developments reinforce our recommendation that investors avoid commingled/last-man-out risks and directly invest in high-quality securities in separately managed accounts with full transparency and control.

The National AFP conference is right around the corner. If you plan on attending, please reach out to your portfolio manager or salesperson to coordinate a meeting or join us at our gathering at Mandalay Bay.

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