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This time the Fed is not ending its QE program, but is merely discussing the conditions under which it would 'taper' or reduce its purchases. These conditions require a continued strengthening of the economy. We therefore urge caution regarding bonds and patience with stocks.

A Correction for Stocks as the Bond Bull Ends

We believe Treasury yields have made multi-decade lows that mark the end of the 30-year bull market for bonds. We further believe that, following the current correction, stocks will recover, with US stocks likely to make new highs before year end. The rise in yields has come as inflation expectations have fallen and growth expectations (real rates) have risen. In other words, the rise in yields reflects better prospects for economic growth, enough for the Federal Reserve to begin contemplating normalizing monetary policy. The transition from a period of easy monetary policy to a more neutral policy can produce volatility, and it has often marked the beginning of a sustained rise in longer term bond yields. Bear markets in stocks are typically associated with central bank tightening and recessions, not economies that are growing sufficiently to allow central banks to remove some stimulus. Thus we see the decline in stocks as a correction in a bull market.

In the early 1990s, the Fed cut rates steadily until September 1992 (see The Weekly Chart). It was 15 months before they started raising rates in early 1994. During that time stocks had several corrections but continued higher, and largely avoided the bond bear market of 1994 when both long and short rates rose. Again in 1996, the Fed turned neutral, bonds sold off, and stocks suffered a correction only to surge higher. This pattern was repeated in December 1998 when bonds sold off, anticipating higher rates, while stocks moved higher. The 1990s marked a time of above-trend economic growth where the principal fear was inflation, which failed to materialize. In each case it took significant tightening and the fear of recession to cause stocks to break down.

In the 2000s, the recovery was initially sluggish and the Fed cut rates steadily until June 2003, which marked the low for bond yields, while stocks rose for the next four years despite rising short, intermediate, and long-term rates. Former Fed Chairman Alan Greenspan's famous 'measured' pace of increasing rates caused some corrections but not an end to the stock bull.

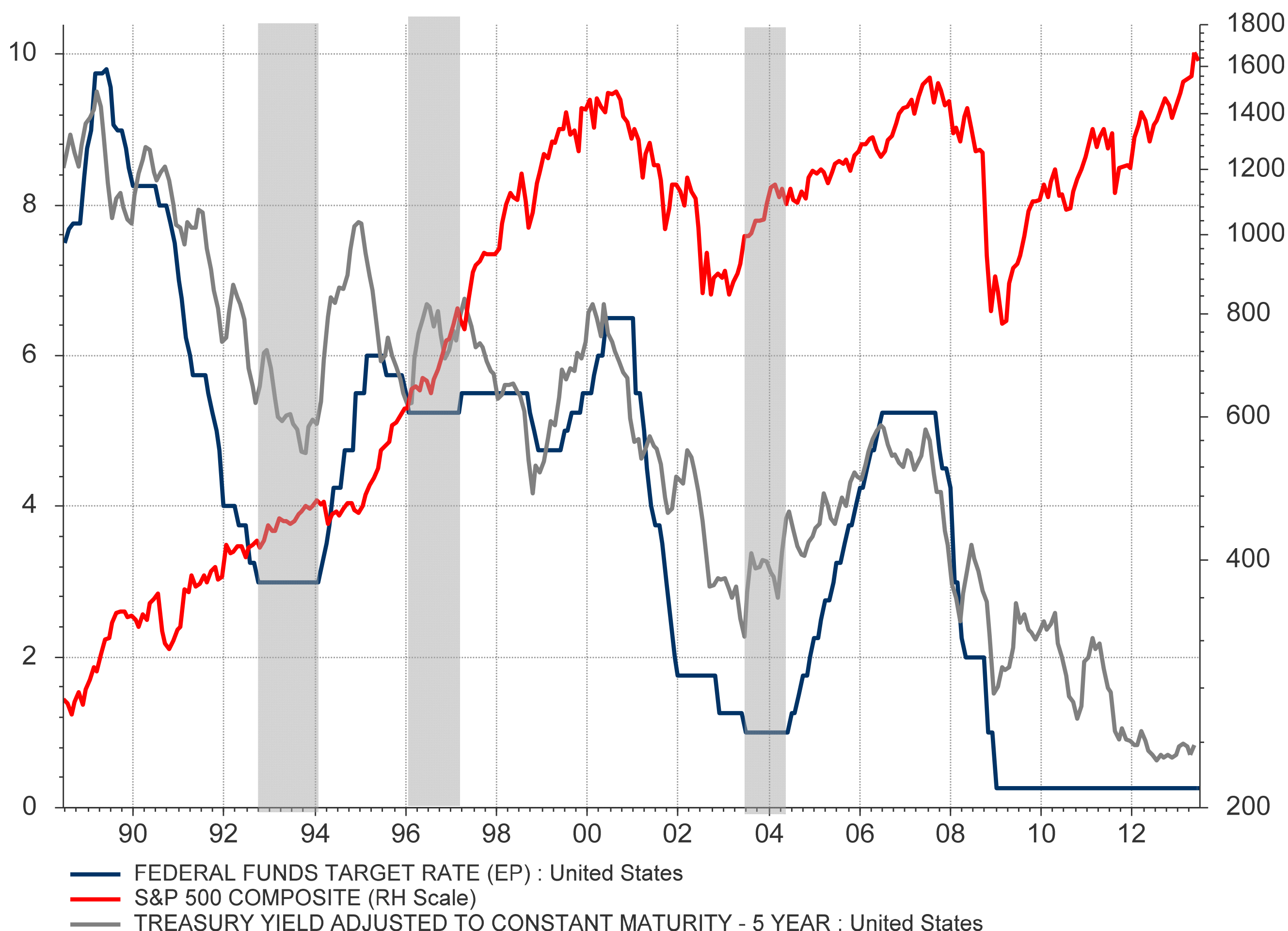
The most recent cycle is different because the Fed, having reduced short-term interest rates to 0.25% in January 2009, has been using its bond purchase program, known as Quantitative Easing (QE) to implement its policy. The 2010 and 2011 corrections both occurred due to the prospect of the end of QE programs (and other global crises), but did not mark the end of the bull market for stocks. This time, the Fed is not ending its QE program, but is merely discussing the conditions under which it would 'taper' or reduce its purchases. Chairman Bernanke has clearly made policy 'data dependent,' so good news for the economy is clearly bad news for bonds, but we believe good news for the economy will ultimately be good news for stocks, especially more cyclical stocks. We therefore urge caution regarding bonds and patience with stocks.

From a technical perspective, we think the correction in US stocks is overdue following a six-month assent that was annualizing at an unsustainable 40% pace. We expect the S&P 500, which closed at 1572 last week, to find strong support in the mid-1500s.

Emerging Market Stocks, Bonds, And Currencies

Last week we expressed our shorter-term concerns regarding emerging markets; in fact, we reduced our weightings in emerging markets across all of our portfolios last Monday. Our two most conservative portfolios are now at a zero and 1.5% weighting, respectively. Emerging market stocks are down about 10% since we sold. Financial repression in the US has benefited emerging markets as global investors have sought higher yields, funded by ultra-low US rates. Now with the Fed beginning to plan an exit, emerging market bonds and currencies are suffering, with higher funding costs lowering expected growth and hurting stocks.

THE WEEKLY CHART: LESS ACCOMMODATIVE FED HAS HISTORICALLY BEEN BAD FOR BONDS BUT NOT FOR STOCKS (SHADING SHOWS PERIODS WHERE EASING ENDED)



Source: Thomson Reuters Datastream

Our chart shows five-year Treasury bond yields and the Fed Funds rate (i.e., intermediate and short-term interest rates, left scale) and the S&P 500 (right scale). We have shaded the three previous periods in which the Fed stopped cutting rates as described on page one. In no case did the end of Fed easing mark an end for rising stock prices, but in the latter two periods it clearly marked the low for intermediate bond yields.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Technical analysis is based on the study of historical price movements and past trend patterns. There are also no assurances that movements or trends can or will be duplicated in the future. Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.