The Reilly Report:

2013 REVIEW AND OUTLOOK FOR 2014
Monetary Policy is the Key

The year 2013 was an outstanding one for stock market investors in the developed world. Led by a 50% gain in Japan and a 30% gain in the US, investors celebrated another strong year of the 2009-2013 bull market. Germany, England, and the rest of Europe rose strongly too. (See Figure 1) However, it was a different story in the developing world. Stock markets in rapidly growing China, Indonesia, Thailand, and Brazil fell for the year, with the most serious losses coming in the summer of 2013 when the US Federal Reserve (The Fed) first suggested the possibility that its program of Quantitative Easing (QE), which was injecting $85 billion a month of liquidity, would be tapered in the future (See Figure 2). Even though the Fed did confirm later that "tapering" would start in early 2014, and could even be completely wound down by the end of 2014, the bull market continued unabated in the rich countries, while developing countries' markets did not recover their losses. Among the largest

Figure 1: **Developed Country Stock Indices**

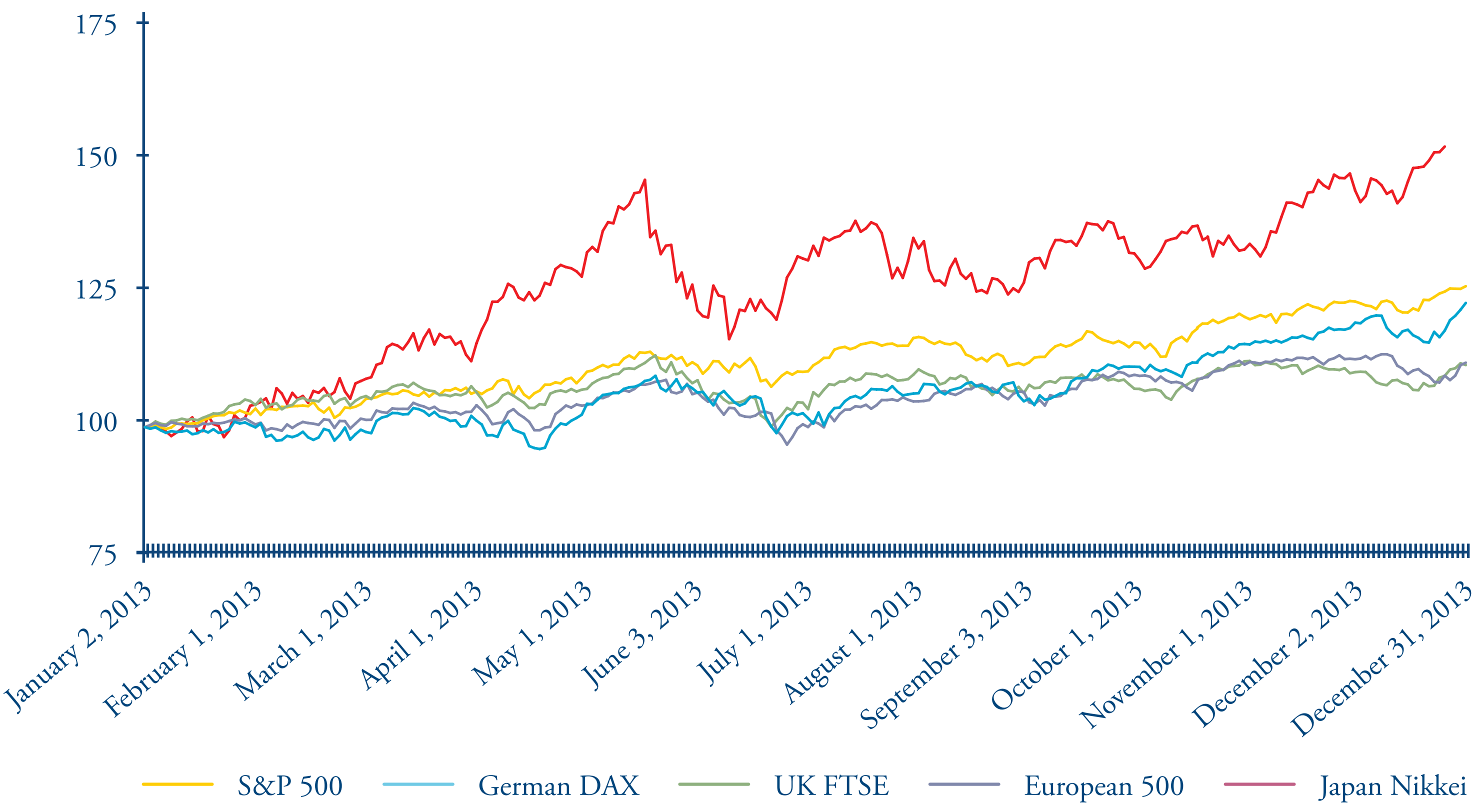

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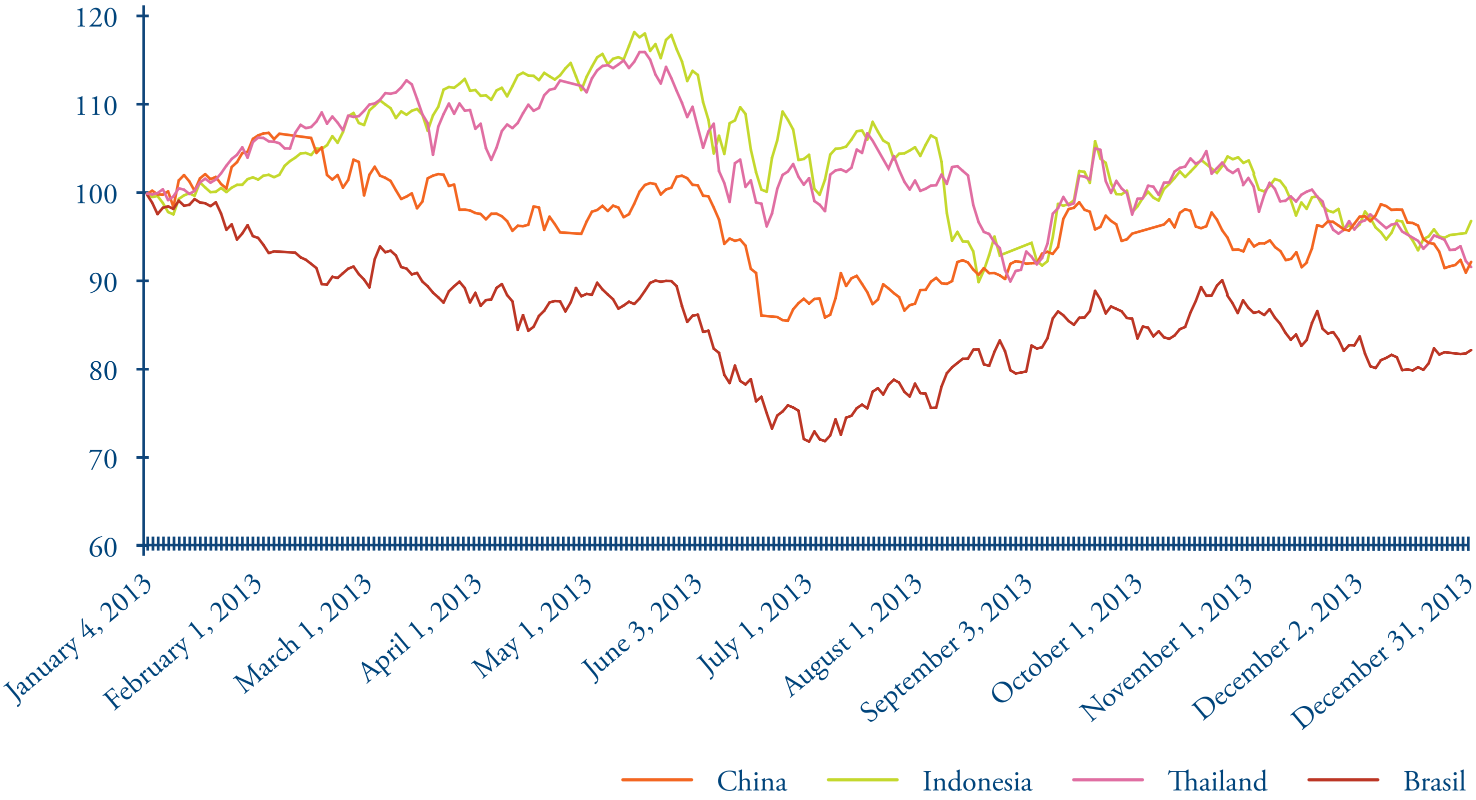
Figure 2: **Developing Country Stock Indices**

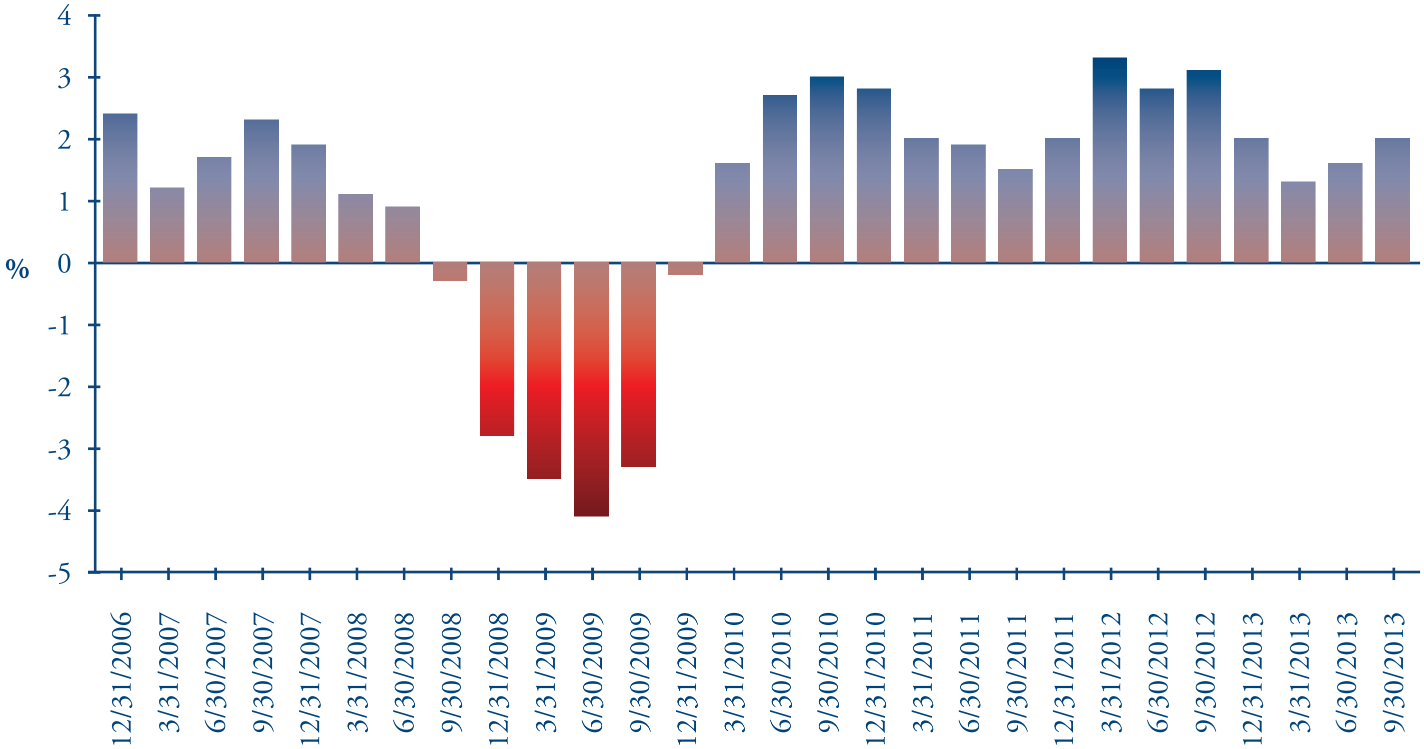


developing countries, only India managed a gain for the year, after overcoming a very steep drop in the summer. While every country's market is moved by domestic factors as well as international, 2013 made it clear that monetary policy, especially in the US, has an outsize effect around the world. When the European Central Bank (ECB) and Bank of Japan (BOJ) reinforce the Fed's aggressively easy money, the entire world gets a positive economic stimulus.

Since the world economy and financial markets will continue to be strongly affected by monetary policy, it is vital to understand the Fed's strategy and objectives. How did we get to QE? What will happen when it ends? How will this affect financial markets and the real economy?

Although the US Fed did not foresee the worldwide credit and economic collapse of 2007-09, Ben Bernanke and the Federal Open Market Committee (FOMC) did respond to the crisis rapidly. A glance at Figures 3-5 shows how far the US economy fell, and how sharply the Fed reduced interest rates to counteract the economic and financial contraction. By comparison, when Japan's real estate and stock market bubbles burst in 1990, the BOJ did not respond boldly, and the Japanese economy suffered for two decades. Only recently did the BOJ take truly extraordinary measures to shock the economy into sustained growth; these measures also ignited the tremendous rally in Japanese stocks in 2013.

Figure 3: **US Real GDP**



Unfortunately, the Fed's conventional monetary stimulus, provided by zero short-term interest rates, was not sufficient to drive US economic growth to levels normally seen after a deep recession. In fact, another look at Figures 3 and 4 shows a very tepid recovery. Of course, the US economy was weighed down by economic weakness in the rest of the world, especially Europe whose Eurozone was nearly fractured by the depression-like conditions in countries like Greece and Spain, and the ensuing fears of government default (a reality in Greece, of course). The US FOMC concluded that unconventional monetary policy was necessary to speed up economic growth, and thus QE was born. The essence of QE is a nearly unprecedented attempt by the Fed to bring down long-term interest rates, since zero short term rates were not sufficient to reinvigorate the economy. Since housing and much

Figure 4: **US Unemployment Rate**

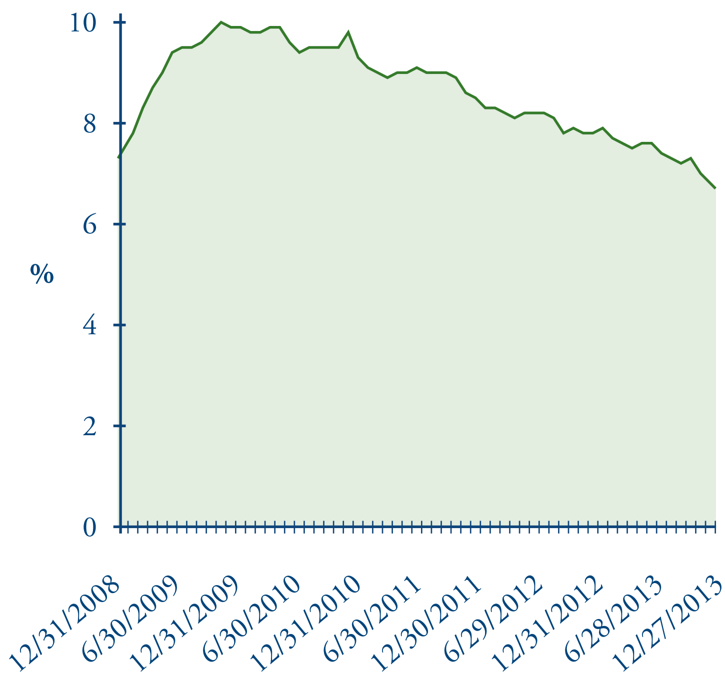


Figure 5: **US 3 Month T-Bill**

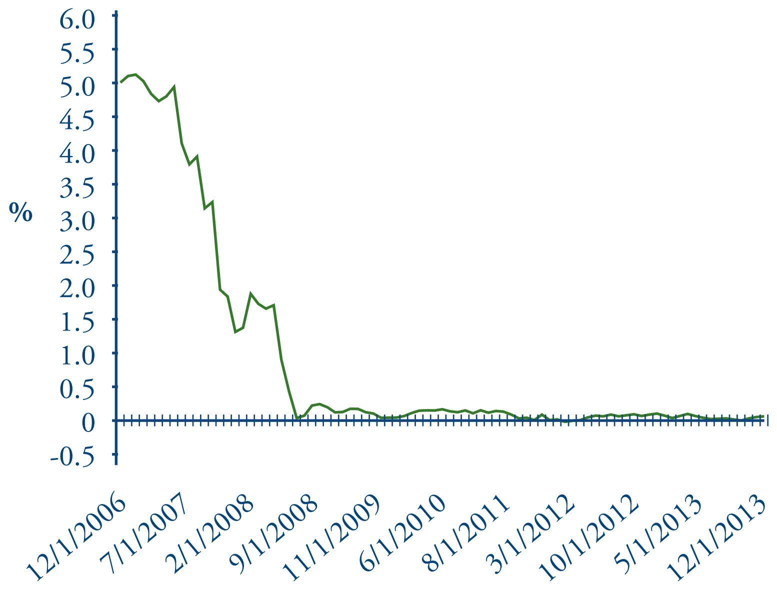
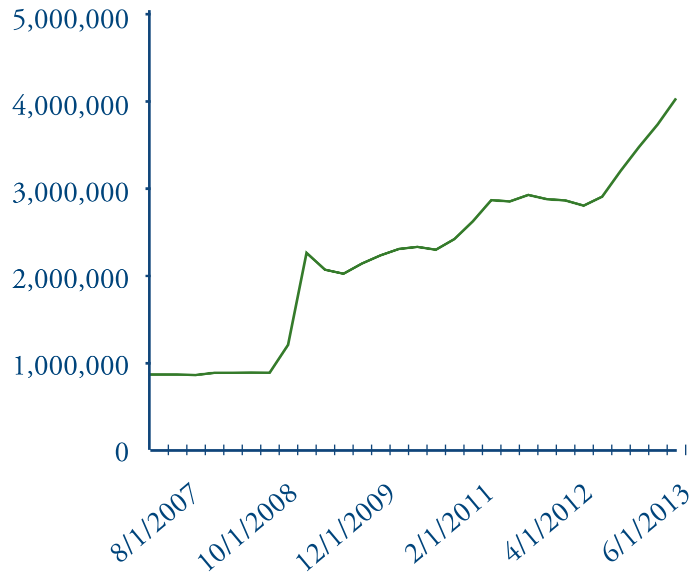
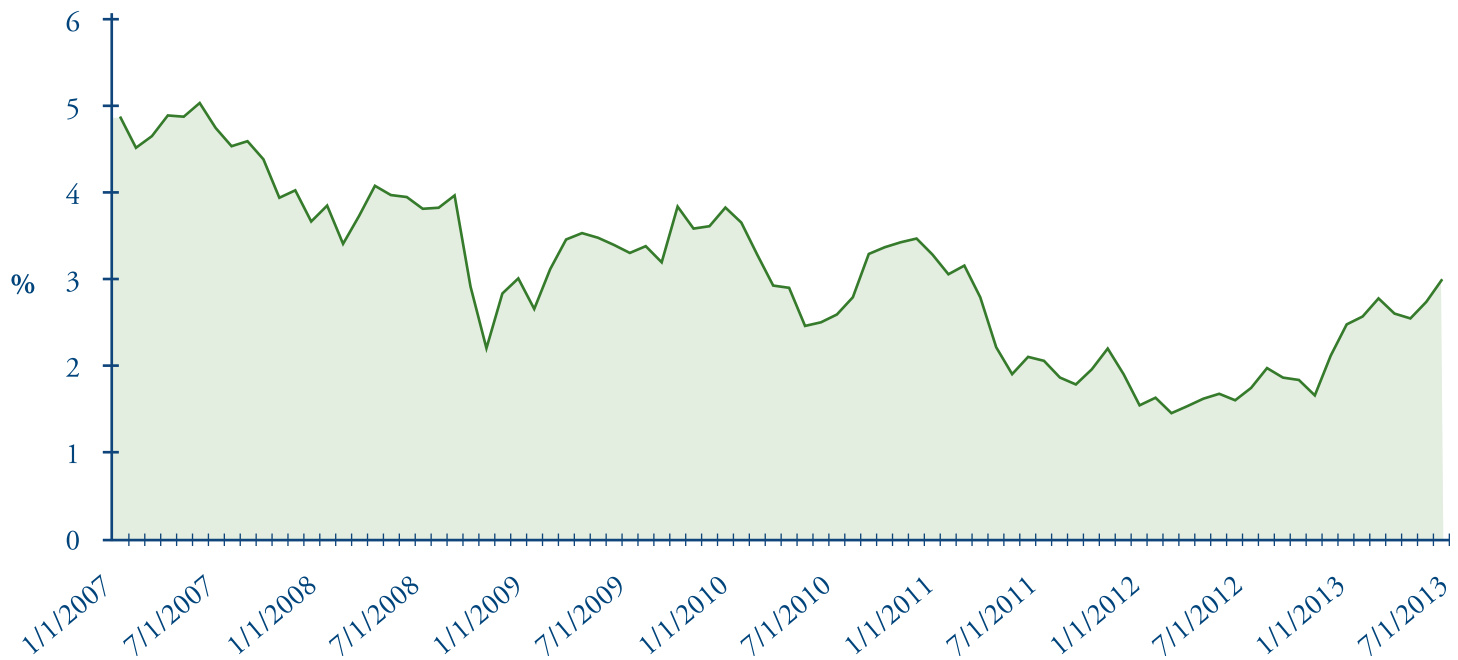


Figure 6: **US Federal Reserve Total Assets**



borrowing and spending are more heavily influenced by long-term rates, the Fed concluded that massive purchases of long-term US government securities and mortgage bonds would push down long-term rates; thus stimulating the housing and construction sector which had collapsed in 2007-09, and consumer spending and business investment which had also fallen sharply and were recovering only weakly. The extent and effect of the Fed's purchases, recently $85 billion a month, are clear in Figure 6, and in Figure 7.

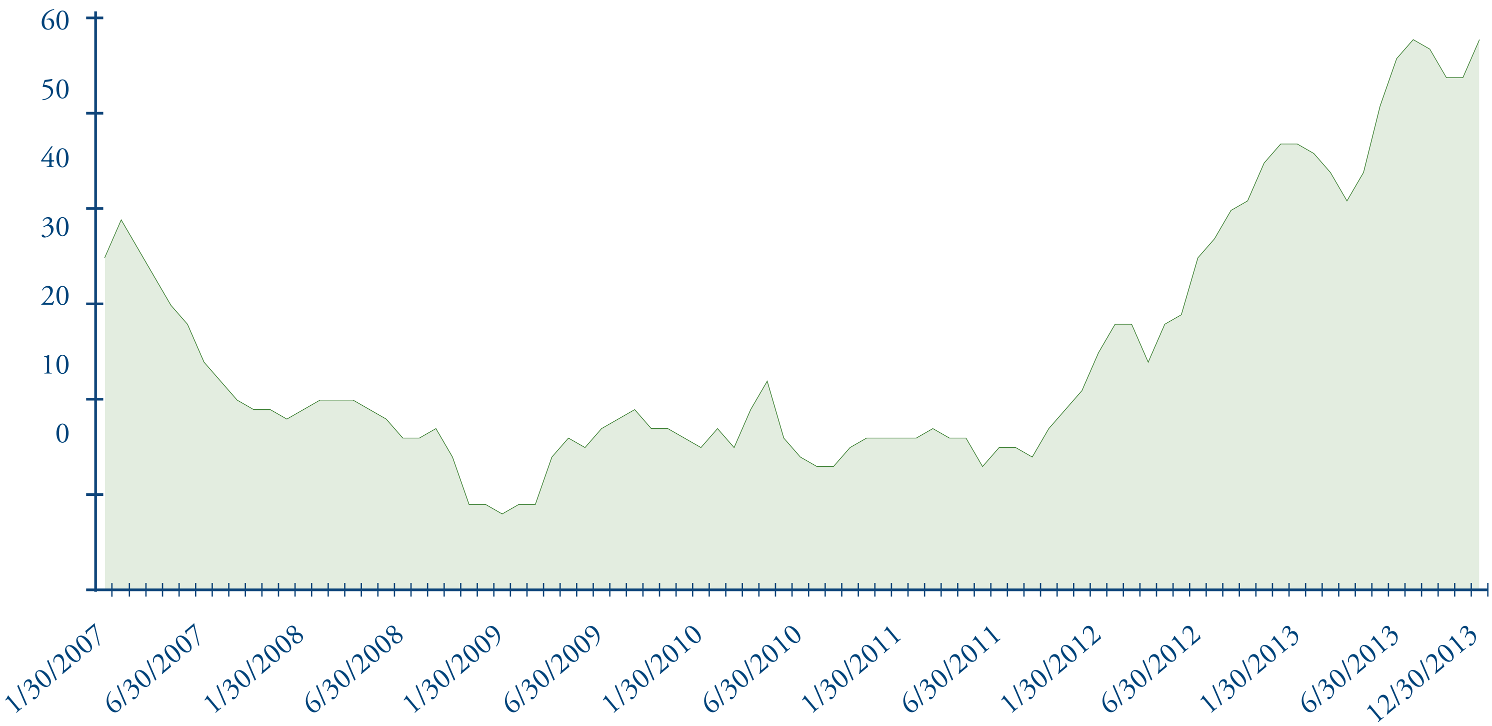
Figure 7: **US Govt 10 Yr Yield**



By the end of 2013, it seemed that the US economy might finally be returning to more normal levels of growth, and conditions in Europe were stabilizing, with even a few signs of forward momentum. Housing construction and prices in the US responded to ultra-low mortgage rates which had been engineered by QE (see Figure 8) and the stock market, which is always the first to respond to easy money, soared throughout the year.

The Fed's success in both preventing a second Great Depression, and in (perhaps) finally driving the US economy toward stronger and self-sustaining growth has not come without risks. The Fed must implement an "exit strategy," a gradual withdrawal of monetary stimulus as the economy recovers. This strategy will be overseen by Janet Yellen, who will take the reins of the Fed shortly in what should be a seamless transition given her presence on the FOMC and strong support for Bernanke's policies. The first step the Fed will take is the tapering of QE, slated to be gradual enough that financial markets, and the economy (especially housing) do not swoon again. This is not an easy process, and there is no history to guide the FOMC. When Ben Bernanke first mentioned the possibility of tapering QE, financial markets did fall, and as noted above, many developing country markets did not fully recover. While it is likely that the Fed will complete the taper and end QE in 2014, the FOMC has promised to keep short-term interest rates at zero until well into 2015. This policy should be sufficient to keep the

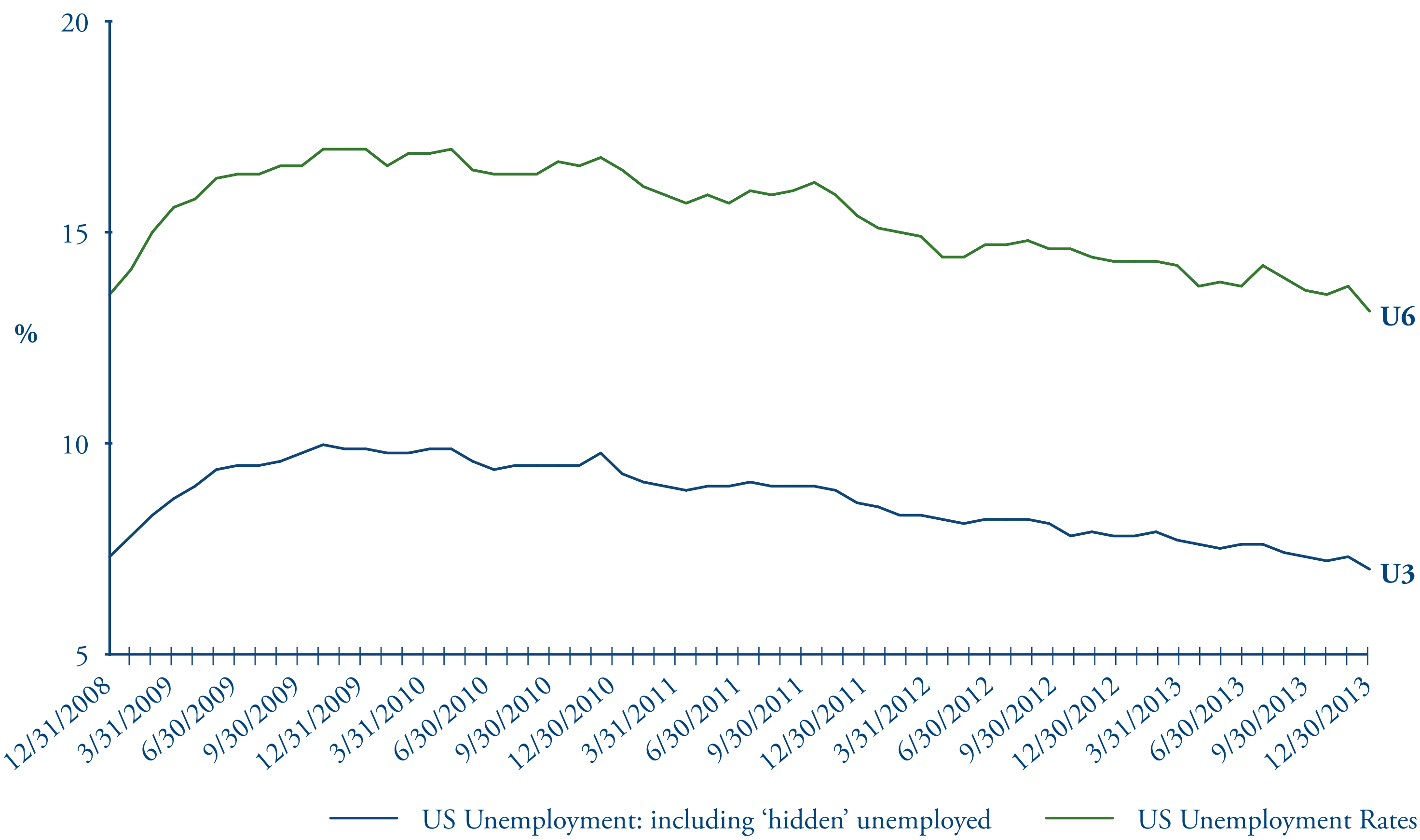
Figure 8: **Homebuilders Sentiment**



economy growing, and even accelerating, especially with help from the ECB and the BOJ. It should also provide support for the stock market in 2014. What is much more difficult to decipher is when the Fed will decide to allow short-term interest rates to rise, and when the Fed will begin to reduce its holdings of $4 trillion of long-term securities. These decisions could have significant impacts on financial markets and the real economy, with knock-on effects throughout the world. One measure of economic health, the US unemployment rate, has been focused on by the Fed to help it determine when to withdraw stimulus. It is quite likely that in 2014 the US unemployment rate will reach the Fed's "target" of 6.5%, since the rate has been falling steadily and reached 6.7% in December (Figure 4). Since the Fed has a dual mandate, to ensure both maximum economic growth and price stability, it must not drive the economy beyond "full employment:" tightness in labor markets could spark inflation, the bête noire of every central banker. Yet it is unlikely that the Fed will pivot toward tighter money when we reach the 6.5% unemployment level. A glance at Figures 9 (U6 Unemployment vs U3) and 10 (Inflation) shows why.

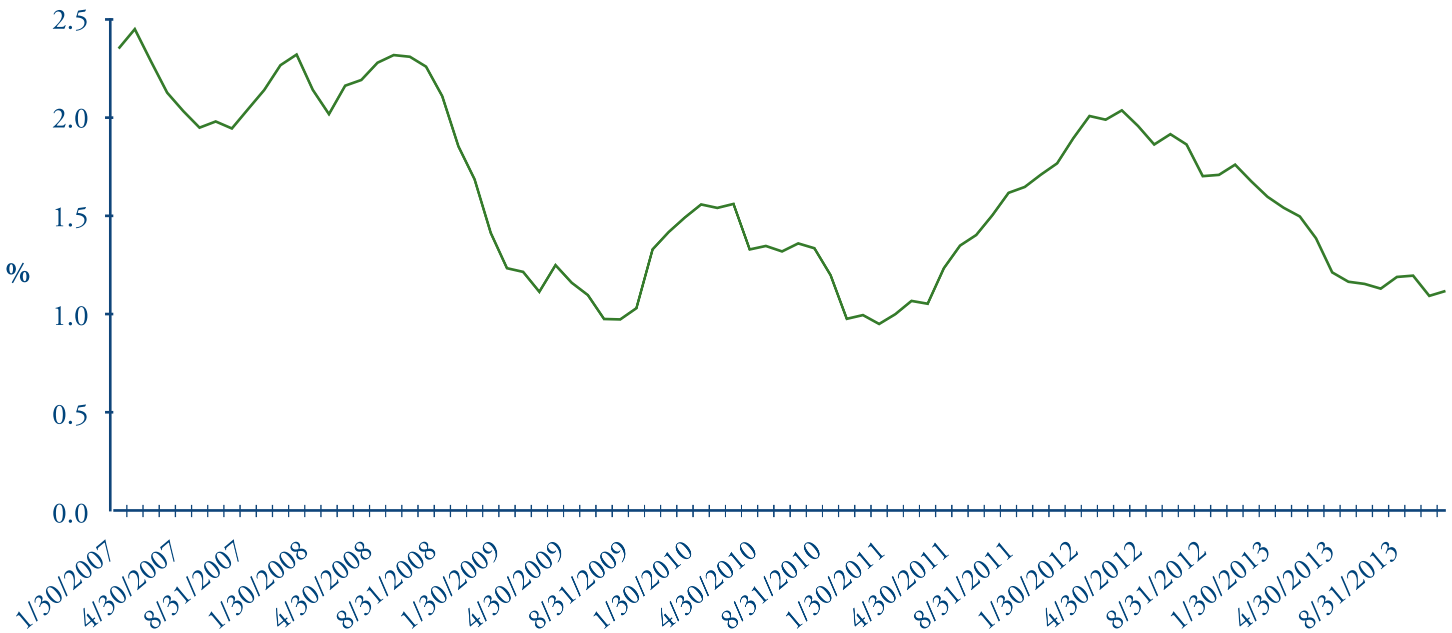
Figure 9 shows the "headline" unemployment rate (technically known as U3) and another rate (U6) which includes workers who want work and are too discouraged to look (by definition kept out of U3) and workers who want full-time work but are stuck in part-time jobs (counted as fully employed in U3). The broader definition of unemployment

Figure 9: Alternative US Unemployment Rates



shows that there is still substantial slack in the US labor market, and therefore the Fed can keep its foot fairly firm on the monetary gas even when 6.5% unemployment is reached. At the same time, the Fed has plenty of room for maneuvering because the inflation rate in the US (and in many other developed countries) is very low and falling (Figure 10). In fact the Fed has aimed for 2% inflation, and has been "undershooting" all year.

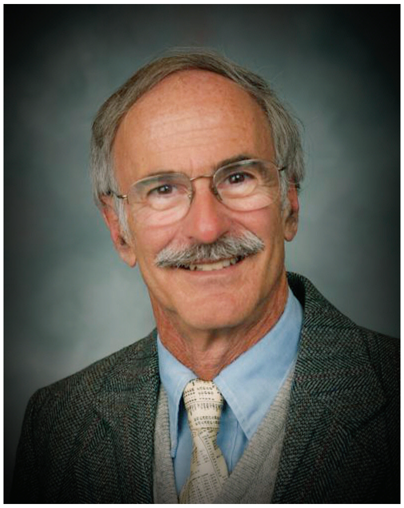
Figure 10: US Consumer Price Inflation



Thus we can expect that monetary policy will remain easy in 2014, the economy will pick up some speed, and stocks should benefit from both of these trends. Rising stock prices in the US could again lead the rest of the world higher, although a repeat of 2013's stellar performance is unlikely. Of course, even though we have highlighted the overriding importance of monetary policy, much else affects financial markets. A new crisis in the Eurozone, a US confrontation with Iran or North Korea, or even rising tensions in Asia stoked by the Chinese, could derail the stock market rally. Closer to home, partisan wrangling over fiscal policy and the upcoming mid-term elections could add to investors' uncertainty. But of course risks like these are exactly the reason that long-term investors are rewarded so handsomely for holding stocks.

Our review and outlook is not complete without a brief discussion of interest rates and the bond market. For the first time in many years, bond holders suffered losses in 2013, as interest rates rose even before the Fed began the taper of QE. It is quite likely that rates will rise again in coming years, as the Fed implements its "exit strategy," depressing returns once more. Yet bondholders have had a tremendous 30-year run since the double-digit interest rates and inflation of the 1970s and early 1980s. Since bond prices often do not move in tandem with stock prices, bonds can still provide diversification for conservative portfolios.

About Dan Seiver:



As Chief Economist at Reilly Financial Advisors, Dan enhances the firm's global macroeconomic approach and outlook, ensuring that all portfolios are managed within the context of the global economy.

Dan has been a member of the Finance faculty at San Diego State University for many years, where he has taught an array of courses including international business finance, investments, and financial literacy. For the academic year 2012-2013, Dan taught full-time in the Economics Department at California Polytechnic University at San Luis Obispo. Dan received the International Business teaching awarded in 2012, as well as the Finance teaching award in 2007. From 1978 to 2005, he was a Professor of Economics at Miami University (Ohio), where he taught a variety of courses in economics. He has over 20 publications in professional journals. He also coauthored an MIT Press book on regional economic policy, and a Probus/McGraw-Hill book on investment strategy. Dan has also been a consultant to the Center for Naval Analyses, and was the investment adviser to the Population Association of America for many years.

He earned his Bachelor of Arts, Masters and Ph.D., all in economics, from Yale University.