First Trust
Monday Morning OUTLOOK
June 24th, 2013
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Back To Normal

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Market behavior – especially since Fed Chair Ben Bernanke mentioned QE tapering – has been relatively dramatic. Not unprecedented, but dramatic. By contrast, the reaction of the punditry has been way over the top.

If the Fed were a baby, last week's move was the equivalent of crawling. It "announced" it was maybe, sorta, kinda, thinking about ending QE sometime in the next year. This isn't even a baby step, but some who used to complain about easy money now complain the Fed is sprinting toward tightening and are mad that the Fed is apparently disrupting bull markets in stocks and bonds.

But fearing an end to QE is giving QE too much credit in the first place. While the conventional wisdom says QE artificially held down interest rates, boosted stock prices, and/or risked hyper-inflation, we don't believe any of this.

First, we don't think QE actually works. Yes, the monetary base has jumped dramatically, but the M2 measure of money is still growing along its long-term 6% trend.

Second, QE itself has not lifted asset prices. Price-earnings ratios are *lower* today than they were in 2008 when QE started and long-term bond yields are low because the Fed has promised to hold short-term rates down near zero. If the Fed says it will hold the funds rate near zero for three years, then the 3-year Treasury yield will be near zero, too.

Third, gold was massively overvalued, driven up by overwrought predictions of hyperinflation. Some investors were obsessed with the monetary base and ignored that the vast bulk of QE ballooned excess reserves held by banks, which does not boost the money supply.

Fourth, moderate "Plow Horse" economic growth is not due to QE, but a combination of new technologies – fracking, 3D-printing, the cloud, smartphone, and tablet – being offset by the burden of big government spending and regulation, which work against growth. It's not all a "sugar high."

Finally, the Fed has changed nothing so far. Nada, zero, zilch. It's still buying $85 billion in bonds every month – the same as the last several months. Everyone knew the Fed would say it, then slow it, then stop it,…and only then raise interest rates and unwind it. And each will only happen when the Fed thinks the economy can handle it. In other words, all these fireworks are a little overwrought.

The acceleration in market moves in recent days, other than for stocks, is not all that surprising. Gold and bonds have been overvalued and stocks have been cheap. Compared to a year ago, asset values have moved exactly like the fundamentals say they should have.

But those who have based their entire economic narrative on Fed action and QE are now adrift. Hyper-inflation has not appeared and the economy is doing OK. In other words, the whole "sugar high" theory is not working.

Bond yields are probably on their way higher. During past easing cycles, the spread between the 10-year Treasury and the Fed funds rate has been above 3.5%; currently it's 2.4%.

Some worry that these higher bond yields mean lower stock prices and weaker housing activity and a slowdown in the economy. But, we use a 4.5% Treasury yield as a discount rate in our stock models and these models still say stocks are still undervalued. We do not believe the recent drop in stock prices is a long-term move and expect equities to move higher in the months ahead.

The same holds true for the economy. The US economy has grown just fine with much higher real yields than exist today. The bottom-line is that fears over the Fed are misplaced and an over-reaction.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-25 / 7:30 am	Durable Goods – May	+3.0%	**+3.7%**		+3.5%
7:30 am	Durable Goods (Ex-Trans) – May	+0.0%	**-0.2%**		+1.5%
9:00 am	Consumer Confidence – Jun	75.0	**75.2**		76.2
9:00 am	New Home Sales – May	0.460 Mil	**0.464 Mil**		0.454 Mil
6-26 / 7:30 am	Q1 GDP Final Report	2.4%	**2.4%**		2.4%
7:30 am	Q1 GDP Chain Price Index	1.1%	**1.1%**		1.1%
6-27 / 7:30 am	Initial Claims Jun 22	345K	**350K**		354K
7:30 am	Personal Income – May	+0.2%	**+0.2%**		+0.0%
7:30 am	Personal Spending – May	+0.3%	**+0.3%**		-0.2%
6-28 / 8:45 am	Chicago PMI	55.0	**54.2**		58.7
8:55 am	U. Mich Consumer Sentiment- Jun	83.0	**83.0**		82.7