

# THE OMNIVEST MARKET VIEW

Investments



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## Another Tapering Opportunity

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The FOMC (Federal Open Market Committee) meets again on December 17<sup>th</sup> and 18<sup>th</sup> for its final meeting of the year. The discussion will clearly center on whether the Federal Reserve should begin the tapering process. Since Congress seems to have cobbled together a budget agreement, the Fed should decide to reduce its purchases of Treasury and mortgage securities.

The back-up in long term Treasury yields since mid-May strongly suggests that fixed income investors have already adjusted to the fact that tapering will indeed occur. It's just a matter of when. Delaying the process into the New Year could put additional upward pressure on yields, should upcoming economic data continue to prove positive. Investors will likely sell on the release of stronger economic data, forcing the Fed to taper early next year.

Unfortunately, it is the investor who is harmed by the lack of action by the Fed. Since May 21<sup>st</sup> when Fed Chairman Ben Bernanke first talked about tapering, the price of the 30-year Treasury bond has fallen 18.40% while the price of the 10-year Treasury note has fallen by 7.90%. Clearly, the lack of tapering did not help the price action in the Treasury market. Investors, who purchased long term treasuries hoping that tapering would not occur, are now saddled with significant losses. As a result fixed income investors will likely sell into any market rally that may occur, thus limiting potential future gains.

The Fed is still clearly concerned about the fragility of the economy, but they should be even more concerned about what higher interest rates will do to the still fragile US economy. It is clear that the Fed is losing control over long term interest rates given that 30-year yields have risen from a low of 3.13% in mid-May to a current yield of 3.87%.

Investors are eager to know when Fed tapering will begin. Uncertainty has not been a friend to the bond investor. If the fixed income markets have already priced in a likely tapering in December and/or January, so too must have the equity markets. So again, we ask, why should the FOMC delay the inevitable slowdown in asset purchases? One argument could be the low rate of inflation which is currently sitting at 1.10% as recently measured by the Core PCE (Personal Consumption Expenditure). Even though inflation is lower than what the Fed wants, it seems unlikely that the Fed can promote higher inflation by continuing QE into the future.

By maintaining its current program of asset purchases, the Fed is luring investors into making unwise decisions as it relates to stretching for yield in the fixed income markets. For example, investors who purchased 30-year bonds in mid-May will have to hold these bonds for nearly 5 years before interest income can offset the 18.40% price loss mentioned previously, assuming prices don't fall further. Again, the Fed unwittingly may have given false comfort to fixed income investors by not tapering.