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Greg Valliere Monthly Commentary

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GREG VALLIERE: Well, hello, everybody. It's Greg Valliere at the Potomac Research Group, recording on August 20th. And I think this would probably be a perfect time to take a look at the fall—the big stories that will affect the markets and investors as we get past Labor Day.

I would start with the biggest story of all and that, of course, is the Fed tapering that, in all likelihood, will begin right after the FOMC meeting on September 17th and 18th. I suppose there's an outside chance they might wait if we get a terrible unemployment number on Friday, September 6th... terrible being well under 100,000 new jobs. I don't think it will be that weak. I think the number will be sufficient for the Fed to move after the FOMC meeting.

As many of you know, I have some very good sources at the Fed. And I think the prevalent view there is that they have to start moving, that the cost benefit ratio for quantitative easing has changed. I think they do see increasing costs—cost in terms bubbles in the housing market and elsewhere, cost in terms of having to look at an enormous balance sheet that has to eventually get smaller. The benefits, I think, are dwindling. I don't think there is a clear case that can be made that quantitative easing has done as much as it did when we had QE1. QE2 may have worked. QE3 is a pretty mixed story and a feeling of many people at the Fed, so I do think they will begin.

I think the beginning will be very modest with perhaps just $10 billion being taken off of their monthly purchases. So they're still going to be adding $70 or $75 billion. My sources say it's probably going to be $75 billion after this meeting, with the goal of reducing the level of purchases each time they meet. Or maybe each month, they'll go down another $10 billion until eventually we get to the Fed not adding at all. That would probably not come until the spring, maybe not until early summer of 2014.

I think a key point here is Ben Bernanke's view that the unemployment rate, once it gets to 7%, is a level where they don't have to add anymore. And, as you know, we're at 7.4% now, and we could be close to 7% by the end of the winter, maybe even before then. So they have to start moving, and I do think they will begin to move.

It's also important to note that right away the Fed is going to shift the focus to 'forward guidance,' as they call it. The forward guidance on the Fed Funds Rate will be that the Fed has no intention of raising the Funds Rate for a long period of time. Unemployment would have to probably get below 6-1/2% and stay there before the Fed actually raised the Funds Rate.

As you know, the Fed is very sanguine about inflation. They certainly don't see anything to worry about there. In fact, they worry that inflation, in some respects, is too low, so I think we could go into

2015 before we see the first hike in the Funds Rate. And I think Bernanke and his press conference, and others will make it pretty clear that the Fed is a long, long way away from raising that very important rate.

The other point I'd have to make on the Fed, of course, is the chairmanship. I haven't been writing much about it. I've been pretty circumspect because I work with Don Kohn. He's a consultant for our firm and personal friend. And Don, of course, is on the short list. I think it's probably between Summers and Yellen. But, Don, and maybe Roger Ferguson as well, had been mentioned as possible successors to Ben Bernanke.

A month ago, I would have said that it was Janet Yellen—that she was the clear favorite because of her long, distinguished career at the Fed, because of her intellectual firepower. But there's no question, this President has faith in Larry Summers. An awful lot of democrats on Capitol Hill do not have faith in Larry Summers, but President Obama has been through the wars with Summers and would like to keep him around as a trusted advisor. So I'd say it's a very close call.

I think what may concern the White House is the confirmation hearing, if it's Summers. I think it would be a very rocky show. There would be talk of Summers' very indiscreet remarks, when he was at Harvard, about the intellectual capabilities of women. I think there'll be a focus on Summers' employment history with a lot of Wall Street firms. But I think, most importantly, would be a focus on Larry Summers' regulatory views, his dismissive view that anything should be done about credit default swaps and he was proved wrong on that, as was Bob Rubin and, of course, Alan Greenspan.

So there's a lot of fodder, I think, for critics of Larry Summers, not to mention the fact that his personality is famously difficult. So it would not be an appointment well-received on Capitol Hill by democrats. I think he probably could win confirmation, but he could be pretty beaten up during the confirmation process. Whereas, I think Janet Yellen could be easily confirmed and Don Kohn and Roger Ferguson also could be easily confirmed.

The important point here, I think, is regardless of who is the next Fed chairman, this Fed will maintain a very accommodative, very dovish stance for at least the next couple of years before we really see interest rates—the Fed Funds Rate—begin to rise. So that's going to be the big story in September.

We also will have other stories. And very quickly, let me tell you that I think that chances of a government shutdown, when the new fiscal year starts in October 1st, are fairly slim. They're not zero. Maybe there's a 20% chance, but I hear from more and more republicans who are very leery about this tactic.

There are some real fire-eating conservatives—Ted Cruz of Texas, Rand Paul of Kentucky—who have talked about shutting down the government in an effort to kill Obamacare. But I think that would backfire on the republicans. They would get blamed. And many of the republican elders, people like John Boehner and Mitch McConnell are pretty much opposed to that tactic, so I don't see that happening.

I think we'll begin the new fiscal year on October 1st the same way we begin most fiscal years, and that's with a continuing resolution, a CR if you will, that will keep the government operating probably through Thanksgiving. Then we'll have a big fight, a really big fight on raising the debt ceiling. That's the fight that could worry the markets, but I don't think a government shutdown on October 1st is very likely.

October 1st is also a very big day, of course, because registration will begin for Obamacare. I think that it's going to be a rocky ride for the White House, but chances that Obamacare would be killed or that there would be any more significant changes I think are very unlikely. I do think it will begin. Many democrats I talked to worry about the impact on their prospects for the 2014 Election, because they feel Obamacare could be an albatross, but I do think it will start on October 1st.

Another big story that you're going to hear a lot about this fall, we talked about last month, and that is prospects for Tax Reform, so I won't belabor my view that the chances are pretty slim. You're going to see some key committees begin markup of Tax Reform, but I don't think you'll get anything done on that in 2013.

Obviously, geopolitics will be a significant story, as Egypt, seemingly careens into chaos, perhaps, God forbid, even the Civil War. At some point, that could really have an impact on oil prices, if people worry about the stability of the Suez Canal.

I don't see a wider Mideast war anytime soon. I think that the likelihood of negotiations between the Israelis and the Palestinians and, even more importantly, the Israelis and the Iranians will defer any threat of a wider Mideast war, I think, for many months, so I'm not quite as concerned on that. So that's it for this month.

I would just close by saying that the one thing that none of us can quite figure out is how much of the Fed tapering is already in the market. Just as I think that the markets have fully accepted it, along comes a decent economic number and people say, 'Oh, my God, the Fed is going to taper in September.' Yes, they are going to taper. I think it's in the market. I think Ben Bernanke will try to calm people down by indicating how far we've got to go before the Fed Funds Rate goes higher. But the market is going to get skittish on this, and I think the first concrete sign that the Fed is taking away the punchbowl could still be one that the markets would view with some anxiety.

So it's possible for the next several weeks we're going to have some volatility. Once the Fed begins tapering, I think maybe we'll see things calm down, because the final point I'd make is that the reason they're tapering is not because of inflation. The reason they're tapering is that the economy is gradually getting better.

So that is it for this month. I look forward to talking to all of you again in mid September. So long, everyone.