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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 June 25th, as we begin summer, with many issues, I think, getting quite a bit of attention in Washington and in the markets. I thought I would focus on three big ones that I think will be in the news quite a bit over the next month or so. Those three are, first of all, Ben Bernanke's testimony before Congress in mid-July; second, the ongoing debate on immigration reform; and, third, a story that I think is going to start to heat up, and that is the debate over possible tax reform.

Let me start with the first issue, and that is the shocking, in my opinion, reaction by many investors to even a hint from Ben Bernanke that the Fed at some point may begin to taper. In my opinion, this was well-telegraphed. We had a call last month in which I said I thought it would be fall before the Fed even considered tapering, and I still feel exactly the same way. The fact that there was a stampede by investors out of bonds, I think is very disconcerting to the Fed, because within the Fed, I am told, they're still not convinced the economy is fully out of the woods, with GDP still pretty mediocre, with Western Europe basically still in a recession, and perhaps, most importantly, with no inflation. The inflation indicator the Fed looks at the most, the PCE, Personal Consumption Expenditure deflator, is actually dropping, and has fallen over the last year.

So I don't think this Fed is in any hurry at all. I think Bernanke felt compelled to let people know at some point they can't keep adding $85 billion a month, but I think because of the negative market reaction when Bernanke testifies before Congress in his biannual hearing—they used to call it Humphrey Hawkins—I think he will make it very clear that the tapering will be extremely tentative and slow, and timid, if you will. I don't think there's even a guarantee they will begin in September. It could be later this year before they decide to go from $85 billion a month in purchases down to $60- or $65 billion. And, of course, they would still be adding to the balance sheet, and I would argue, they will still be adding to the balance sheet well into 2014.

And this idea in the futures market that the Fed Funds Rate might start to go up by 2015, I think that's a little premature. I don't think the Fed is in any rush at all to raise the Funds Rate. And it's worth noting, as I have on previous calls, that Ben Bernanke, in all likelihood, will be replaced in January by Janet Yellen, who is even more dovish than Bernanke is.

So I think the Fed will stay extraordinarily accommodative for quite some time to come, with interest rates still remarkably low. As I record this on June 25th, there's been obviously a blip in rates, getting above 2.50% on the Treasury 10-Year Bond yield. I'd be surprised if we got much higher than that, because the Fed, as I said at the beginning of this call, I think will try to jawbone rates back down.

So that's the first subject, a very highly awaited Bernanke testimony before Congress this summer.

The second issue that will get an enormous amount of attention, I think, may be a fake-out, and that's immigration reform. The Senate will pass it overwhelmingly, perhaps before the July 4th break, maybe a little bit after, but I think that they will probably get 70 votes, including 15 or 16 Republican votes for the bill in the Senate, which you would think might give this some momentum as it moves to the House. But the House is really dysfunctional right now. They had a vote on the Farm bill about a week ago that exposed deep rifts within both parties on policy.

And John Boehner, who I know and think is a pretty good guy, is having more and more trouble controlling his own troops. They are very rebellious. The hardcore conservatives don't want anything. They really don't want immigration reform. They feel it's a form of amnesty, and the Republican base, the very vocal base around the country, feels the same way. So I think the House will stall and take many months, and perhaps mark-up little bits and pieces of immigration reform, but probably not get a bill over to the Senate so they could begin a House-Senate conference until late this year, if at all.

Of course, one of the complicating factors here is that Barack Obama seems to be pretty much dead in the water. And I don't say that gleefully. A lot of people in the markets are not displeased to see this, but I do think we have perhaps the earliest lame duck president in the history of the country, and I don't see Obama having much clout on issues like immigration. So this story, I think is going to stall, and all of the good stuff in the bill, including a long overdue reform of H1B visas, I think, will stall with it.

The third thing I wanted to mention briefly is going to be the growing focus on tax reform. The House Ways and Means Committee Chairman, Dave Camp, is determined to mark-up a bill in his committee and move it, maybe get it through the entire House by the end of the year. There will be a lot of focus on what individual and corporate tax reform would do. Obviously, a lot of sacred tax breaks could be in jeopardy. On the business side, it could be accelerated depreciation or be research and development tax credit. On the individual side, my gosh-- it could be the mortgage deduction, employer-provided health insurance, the state and local exemption, and on and on and on. I think that as the details become more accepted many of the flaws will become a real albatross for getting a bill enacted. The biggest albatross is that the House and Senate have a fundamental difference.

The House, of course, controlled by conservative Republicans, are adamant that there will be no new taxes, no new revenues raised 'net' in this bill. The Senate, controlled by the

Democrats, wants to use tax reform to raise revenues to help pay down the deficit. And I think that a disagreement of that magnitude pretty much ensures that a tax reform is not going to get enacted this year. I wanted to alert you to it on this call because you will be hearing a lot about the mark-up in the House, but I think it's very unlikely that you can get a final bill with both parties so bitterly divided on this and many other issues.

The final point I'd make is that with all of the infighting and political intrigue and problems, really, within both parties, the most underrated story in Washington, the least appreciated story in Washington continues to be the astonishing improvement in the budget deficit.

This, as I go around the country talking to clients, to some of your clients, is met with incredulity. Many people are not aware of how dramatically the deficit is falling, and I think this trend is now fully in place, so much in place that an extension of the debt ceiling, which most people thought would have to be done in the fall, may not have to be done until early 2014, because receipts to Treasury look so good and because we have real spending restraint. It's a great story. I'll be talking about it more this year. I do think the credit rating agencies are now out of the picture. I don't see a credit rating downgrade at any time in the foreseeable future.

So that's it for this month. Enjoy the summer, and I will talk to you again in a few weeks. So long, everyone.