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Of Tantrum & Policy

Over the past few years, we have adopted many new words and phrases, introduced to us by policy makers, economists and the media including, "European Debt Crisis", "Debt Ceiling", "Fiscal Cliff", "Sequester", and finally "Tapering". These are all economic and political events that have served to shape and constrain the landscape following the "Credit Crisis". It is these events that the next wave of policy makers and future economists will study when they eventually attend institutions of higher learning.

While most would argue that policy makers have by and large done a good job, over the past few years, in their efforts to minimize the extent of recessions and to spur economic growth and job creation, their efforts will forever be critiqued in the classroom.

For instance, one question that professors may pose of their students is, "When did the European debt crisis begin?" While the answer to this question may be the subject of great debate, it can be argued that this crisis started back in 1992 when the members of the European Union signed the Maastricht Treaty. Under this agreement, Europeans were to be offered high levels of freedom, security and justice and in exchange members agreed by and large to limit their deficit spending and debt levels. However, a combination of low interest rates and a strong Euro led to excessive borrowing and government spending, to the extent that, five Euro-zone countries have required assistance from other Eurozone members in order to ensure the ongoing solvency of their financial institutions. As a result, austerity in the form of increased taxation and reduction in spending on social programs has become commonplace as has unemployment (especially amongst younger workers) and has led to social unrest and protests that challenge leadership and ask for an end to the economic ache brought on by these events.

While the impact of Europe's debt issues has impacted economies and financial markets deeply, the US has emerged from their own crisis nicely as the Standard & Poor's 500-stock index in May closed above 1,500 for the first time since September 2000. Despite this success, the decisions that US policy makers have made over the past few years will also be scrutinized and analyzed in the classroom just as much as the decisions made by European policymakers.

Starting with the US debt ceiling, perhaps you remember the angst that most investors felt in the summer of 2011 in the days leading up to the senate vote that everyone hoped would approve an increase to the $14.3 trillion debt ceiling and reign in government spending. After much deliberation approval was granted and the "Debt

Ceiling" then led to the "Fiscal Cliff", a combination of expiring tax cuts and across-the-board government spending cuts that were to come into effect on December 31, 2012. The Fiscal Cliff delayed the implementation of this Sequester (of spending cuts), which went into effect on March 1 and includes spending reductions of approximately $85 billion during 2013, with similar cuts through to 2021.

While all of this transpired, "Quantitative Easing" (QE) continued. This latest round of QE (there have been 2 previously) called for $85 Billion in government bonds to be purchased by the US Federal Reserve, monthly, in the hopes that this increased liquidity would increase both lending by banks and spending by corporations.

While students and professors will forever debate the effects of these policies and stimulus, one thing is abundantly clear; financial markets (at least in the short term) are now very much dependant on the direction and guidance of policy makers. The latest evidence came in late May when the Federal Reserve merely hinted at the eventual end to quantitative easing. This talk of "Tapering" its bond purchase program sent all markets into what many have termed as a "taper tantrum" whereby stock prices immediately dropped sharply and bond yields rose. This negative volatility continued until U.S. Federal Reserve chairman Ben Bernanke raised the prospect that the central bank's monetary stimulus may in fact stay in place a little longer than expected.

So while policy makers will continue to debate the implementation of the next fiscal or monetary stimulus, or merely what to name it, the fact remains that navigating today's market environment is a tricky affair and must be done with consideration given to balancing investor's risk tolerance against their investment goals. As a result, determining the most beneficial asset allocation (the mix of stocks, bonds and cash) has perhaps never been more important.

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