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MARKET INSIGHT

JOHN V. CARBERRY
PRESIDENT
JCARBERRY@FLPUTNAM.COM

ELLEN FLAHERTY
SR. VICE PRESIDENT,
CHIEF OPERATING OFFICER
EFLAHERTY@FLPUTNAM.COM

SUSANNE STAUFFER
SR. VICE PRESIDENT,
PORTFOLIO MANAGER
SSTAUFFER@FLPUTNAM.COM

ROBERTSON P. BREED, CFA
SR. VICE PRESIDENT,
PORTFOLIO MANAGER
RBREED@FLPUTNAM.COM

STEVEN N. VIOLIN, CFA
SR. VICE PRESIDENT
PORTFOLIO MANAGER
SVIOLIN@FLPUTNAM.COM

ELLEN K. HAZEN, CFA
VICE PRESIDENT
PORTFOLIO MANAGER
EHAZEN@FLPUTNAM.COM

D.J. SHAUGHNESSY, CFA
VICE PRESIDENT
PORTFOLIO MANAGER
DSHAUGHNESSY@FLPUTNAM.COM

ANDREW B. WETZEL, CFA
VICE PRESIDENT,
RESEARCH ANALYST
AWETZEL@FLPUTNAM.COM

ROBERT F. TAYLOR, CFA
RESEARCH ANALYST
RTAYLOR@FLPUTNAM.COM

CHRISTIAN D. MCVEY
SR. VICE PRESIDENT,
MARKETING
CMCVEY@FLPUTNAM.COM

WENDY M. BUSH
VICE PRESIDENT,
MARKETING
WBUSH@FLPUTNAM.COM

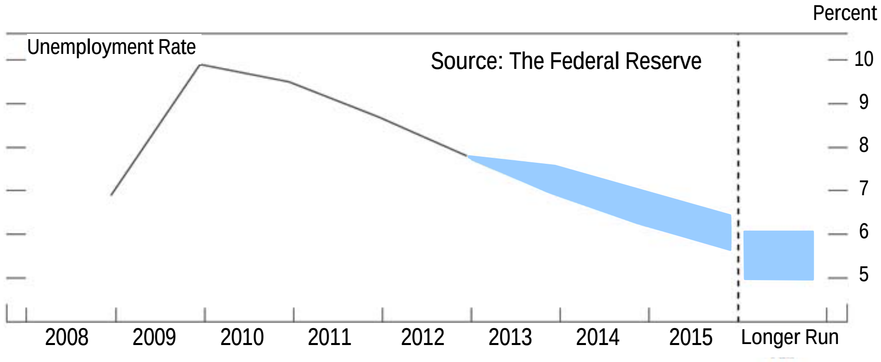
BUZZ FEED

BY ROBERT F. TAYLOR, CFA, RESEARCH ANALYST

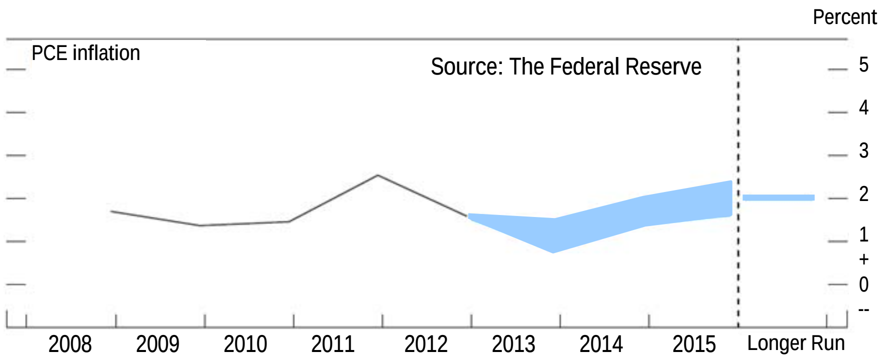
Wall Street has always been enamored with buzzwords. The financial crisis brought us rather ominous terms such as "Too Big to Fail," "Toxic Assets" and "Black Swan." The subsequent recovery coined the more pleasant "Green Shoots," while terms such as "Quantitative Easing," "Bond Bubble" and "Sequestration" have recently entered the financial world's lexicon. The current queen mother of buzzwords is "taper," a seemingly innocuous term that has sent shivers through the markets over the past few weeks. Taper, according to the Financial Times, means the anticipated reduction of the Federal Reserve's quantitative easing, or bond-buying program. The word worked its way into the financial lexicon on May 22nd when Federal Reserve Chairman Bernanke stated in testimony before Congress that the Fed "could in the next few meetings, take a step down in [its] purchases." Since then the S&P 500 is down 3.6% while bond prices as measured by the 10 year U.S. Treasury note, have dropped by 5.3%.

The term Quantitative Easing (QE) was first used in August 2010 when the Fed, concerned that the economy wasn't growing fast enough, began purchasing U.S. Treasury securities (subsequent programs were expanded to include Agency mortgage-backed securities) at an initial rate of $30 billion per month in the hope that such purchases would reduce interest rates, stimulate the economy (and job growth), and create wealth through higher asset prices. The problem with QE is that too much of it can lead to unwanted outcomes, namely inflation and/or asset bubbles, while a lack of effectiveness runs the risk of QE's turning into a policy stance the Fed can't exit, hence the term "pushing on a string." For the most part, QE has been effective to a degree, as low interest rates sparked a strong recovery in housing, the jobless rate has fallen from 8.1% at the beginning of the program to 7.6% currently, and the stock market recently made new all-time highs. Current debate within the Federal Open Market Committee (FOMC) as to the timing of withdrawal is intense, as "hawkish" committee members favor a withdrawal sooner rather than later, vs. their more "dovish" counterparts who see no urgency in curtailing the bond purchase program.

Economists, market pundits, and investors alike have eagerly scrutinized recent Fed commentary for clues to the future direction of monetary policy. Officially, the FOMC has not announced any changes to its augmented policy of buying up to $85 billion worth of bonds per month. In fact, the prepared statement released on June 19th states that the FOMC, in accordance with its dual mandate of full employment and price stability, stands ready to *increase* or *reduce* the pace of its purchases as the outlook for the labor market and inflation changes. However, Chairman Bernanke, in a press conference following the release of the official statement, tied an initial tapering in the pace of purchases (and eventual full withdrawal) to the FOMC's baseline forecast for job growth and inflation expectations over the next year as depicted in the charts on the following page.



FOMC projections for the average civilian unemployment rate in the fourth quarter of the year indicated.



FOMC projections for the annual change in the price index for personal consumption expenditures (PCE). The shaded areas show the range that includes all FOMC participants' projections from lowest to highest in that year.

While acknowledging the current rate of unemployment at 7.6% remains elevated, Bernanke noted that FOMC members have been encouraged with recent gains in private payrolls, now averaging 200,000 jobs per month over the past six months. Committee members expect further gains in private payrolls – thus lowering the unemployment rate to 7.2% by the end of 2013 and to 7% by the middle of 2014. Inflation, currently running at around 1.5%, is below Fed targets, and is expected to gradually rise toward the long-term annual objective of 2%. Importantly, a 2% rate is often associated with a healthy and growing economy. Simply put, should the unemployment AND inflation rates match the Fed's admittedly optimistic expectations over the next 12 months, bond purchases will likely begin to moderate later in 2013 and end sometime around the middle of next year.

Life without QE should be fairly simple for the bond markets to understand, i.e., higher rates via a steeper yield curve. Indeed, the talk of imminent tapering may have initiated the first step in the "Great Rotation," defined as money exiting the bond market by colleague Rob Breed in the March 2013 issue of Market Insight (*Taking Stock*). However, the stock market could be entering a period of extended uncertainty as it ponders the ramifications of a full Fed withdrawal. F.L.Putnam believes that any tapering or withdrawal of asset purchases that are aligned with Fed expectations for job growth and inflation should be positive for stocks in the long run. In recent months, we have been working diligently to identify companies poised to benefit from a strengthening economy – companies with strong growth prospects, solid balance sheets and effective management teams – and using any short-term volatility to invest at attractive valuations.

2013 Market Diary		
	6/30/13	**YTD Change***
Dow Jones Industrials	14,909.60	15.17 %
NASDAQ	3,403.25	13.41 %
S&P 500	1,606.28	13.82 %
Russell 2000	977.48	15.84 %
10-Year Treasury Bond Yield	2.49 %	+73 b.p.

Source: *Bloomberg Capital Markets*

* Includes dividends for equity indices

20 WILLIAM ST., SUITE G40
WELLESLEY, MA 02481
781.235.6323
800.344.3435

WWW.FLPUTNAM.COM

245 COMMERCIAL STREET, SUITE 500
PORTLAND, ME 04101
207.775.3197
800.356.1781