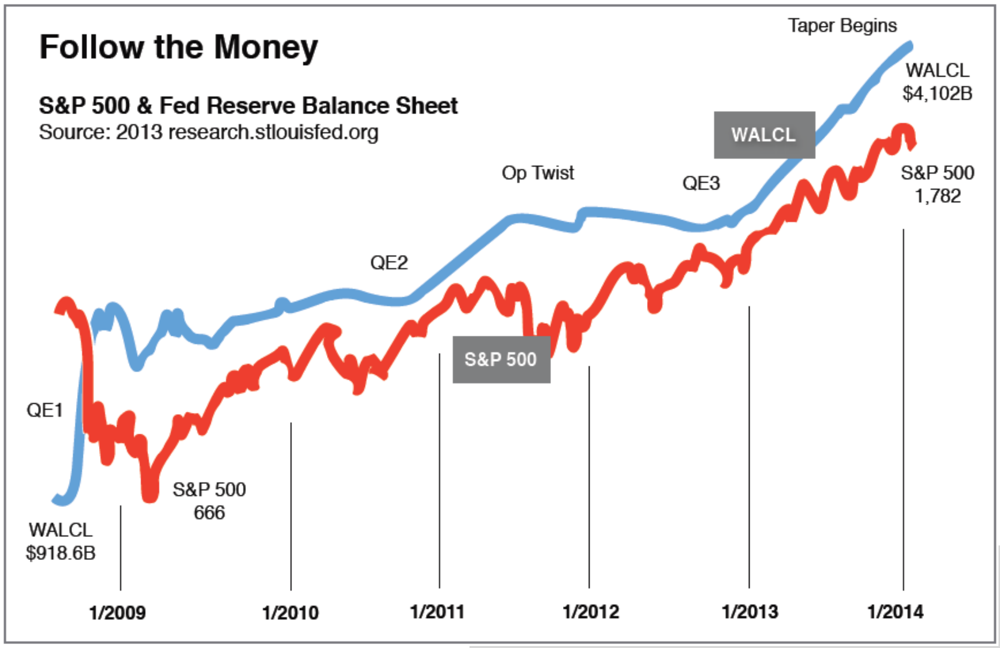
Historic Taper Now Underway
Will Withdrawal Symptoms Be Severe?

At the height of the 2008 global financial contagion, the U.S. Federal Reserve took historic action. Patterned after Japan's own experiment decades before, it launched a bold effort to thaw a frozen financial system and named it "Quantitative Easing (QE)." Never before attempted by the Fed, Mr. Bernanke stepped up in a very large way and implemented a series of bond buying programs. He and his team rolled it out across the country in four waves, over five years that eventually puffed up the U.S. balance sheet to more than $4 trillion dollars. As the colorful Senator Everett Dirksen once said, "A billion here, a billion there and pretty soon you're talking about real money."



WACL: All federal reserve banks – total assets, elimination from consolidation.

Each time the Fed announced and implemented a QE program, the U.S. equity markets advanced, in some cases quite sharply. There was a delay with the first QE as the shell-shocked markets shook off the devastation of the 2008 bear market and struggled to respond to this new form of monetary stimulus. Conversely, each time a QE program ended, the market advances faltered.

While the period under review spans only five years, there were numerous liquidity events introduced by the Fed. In each instance the broad U.S. equity markets took its cue from Fed actions and either rose or fell in concert with monetary stimulus or retraction. It would appear that U.S. equity markets respond promptly to the flows of cheap money.

In June of 2013, Mr. Bernanke rattled the markets when he reminded all that the taper was soon to be implemented. But a stumbling economy in the fall provided a bit more breathing room and enabled a December surprise when the Fed delayed the taper unexpectedly. Global markets surged.

With stocks struggling in the new year, on the heels of the QE3 taper, it is possible that the "Bernanke Experiment" may end up batting 1000 and investors will once again be reminded that the correlation between monetary policy and U.S. equity prices is rather pronounced. Though we admit the time frame is somewhat limited and the global financial backdrop during this period unprecedented, we would not dismiss, out of hand, the relationship suggested by this simple chart.

In sum, Broadmark believes that government monetary interventions, both here and abroad, especially in the massive quantities put forth over the past few years, do matter and perhaps quite a bit.

Where Do We Go From Here?

It would be simpler if all an investor needed to manage equity allocations was the chart we have reviewed above. Alas, markets are dynamic, highly complex mechanisms and a variety of other factors also drive direction and price. Measures of breadth, momentum, and sentiment also help us determine opportune times to adjust our equity exposure.

Given the obvious impact of monetary policy on U.S. equity prices, the assessment of Fed actions continues to be a foundational pillar in our investment process and today warrants even more attention given the bold monetary policies implemented in recent years. Now that concerted efforts are clearly underway to dismantle the QE programs and de-lever the towering balance sheet they have created, we will maintain a keen focus on two monetary factors, in particular.

Absolute levels of interest rates and the velocity of change
The short end of the curve remains buried neared zero and it is clear that the Fed's policy is to maintain this level for the foreseeable future. They have been quite candid in this regard. On the longer end, many have been surprised that the 10-year treasury yield has moderated back comfortably below the 3% threshold in recent weeks and we consider this level now a meaningful cap. A pronounced rise above a 3% yield would be cause for concern.

Credit spreads
Throughout the QE programs, spreads between high yield bonds and treasuries narrowed. More recently, they have widened modestly. We are reminded that Greece's widely broadcast economic troubles unsettled global markets and caused an escalation in spreads. The open question today is whether or not recent emerging market currency turmoil, related to "the taper," will have the same effect.

Either an outright assault on the level of longer rates or a dramatic widening in credit spreads would negatively impact Broadmark's outlook for equities. We continue to watch Fed actions closely and are reminded of the timeless advice from the late Marty Zweig, “Don’t fight the tape.” and “Don’t fight the Fed.”