We wrote after the strong first quarter to expect volatility to increase with stocks remaining the preferred asset class and that is largely what happened in the second quarter. Almost all risk assets wobbled after the Federal Reserve (Fed) hinted at a possible tapering of quantitative easing later this year. Regardless, most domestic stocks did well in the quarter. The S&P 500 rose by 2.91% with small- and mid-capitalization stocks performing about the same. However, international markets struggled, especially emerging markets. The MSCI World ex USA index declined by -2.69%, while the MSCI Emerging Markets index sank by -9.14%.

One of the big stories in the quarter was the dramatic rise in interest rates causing virtually all bonds to lose value. Long dated U.S. Treasury Bonds had been a haven for investors during times of market stress since the financial crisis. But not this time around as evidenced by a popular ETF specializing in this asset class losing -5.59% of its value.

The Fed has taken considerable criticism for their inaction leading up to both the technology and housing bubbles. We suspect the Fed is sensitive to this criticism which motivated them to try to cool, not crush, financial markets after a year of spectacular returns by discussing tapering. However, the market's reaction was more than they bargained for and was not welcomed. Not surprisingly, multiple Fed members quickly backtracked in hopes of jawboning interest rates lower. The bottom line is the Fed is trying to micromanage market expectations which will likely keep volatility high.

About a year ago we became fully-invested in our portfolios largely because the world's central banks were announcing quantitative easing programs, and our clients benefited from the strong rally. But where do we go from here? Current market signals are mixed. Yields have been rising for a year, and Richard Fisher, president of the Dallas Federal Reserve, said: "We've had a 30-year bond market rally. These things do not go on forever." Rising rates sometimes signal an improving economy and could be good for stocks. On the other hand, prices are declining throughout the economy (stock and bond markets, consumer prices, commodities and wages) sending a message of deflation which normally is good for bonds. **The U.S. economy is the world's bright spot with stronger-than-expected (but not robust) job creation, housing, retail sales, and consumer confidence figures, but the recession in the euro zone persists and many emerging market economies are stumbling.**

Given this potpourri of market signals our strategy is to remain *diversified* and *flexible*. This is not the time to take big bets. **On balance we believe rising stock prices and interest rates are signaling a stronger, healthier economy than most pundits expect.** Importantly, deleveraging is progressing quickly with debt service burdens for U.S. consumers extremely low, while loan delinquencies have collapsed. Household net worth soared by $6 trillion over the past year, rising by a stunning $3 trillion in the first quarter of 2013 alone. **Therefore, we remain committed to stocks and hold short duration, high-quality bonds. BUT, we reserve the right to change our mind if future data proves these assumptions wrong.** Our focus will be on corporate profits. With stocks no longer outright cheap, a global economy with plenty to prove, and profit margins at record highs, earnings growth may stall instead of accelerate in the second half of the year.

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WHAT'S NEXT FOR THE FED?

If, as suggested (by us), Bernanke miscalculated the impact that talk of tapering would have on long-term yields, then it stands to reason that the Fed will take steps to ensure that Treasury yields do not continue to surge. Three steps, in particular, are likely:

A later start to tapering. During the press conference last week, Bernanke indicated that a precondition for tapering is that inflation begins "to at least gradually return towards the 2% objective". It is unlikely that this precondition will be satisfied before September, especially in light of the appreciation in the dollar and the decline in commodity prices that has occurred in the wake of the FOMC meeting. And with growth also struggling to meet the Fed's near-term forecast, chances are high that the Fed will only be able to begin tapering in December or early 2014.

The Fed is likely to lower the current threshold of 6.5% for the unemployment rate at which it will consider hiking rates. It is becoming increasingly clear that the decline in labor participation over the past few years is masking the true level of unemployment and under -employment. Bernanke hinted at the possibility of lowering the threshold during the press conference, but he is likely to make this explicit over the next few months. As we discussed last month, lowering the threshold to as low as 5.5% could be justified under the Fed's current mandate of "maximizing employment" if it succeeds in drawing back into the labor force workers who are at risk of permanently dropping out.

A commitment not to sell assets, at least not until the fed funds rate has returned to more normal levels. One of the reasons that Treasury and MBS yields have surged is the growing fear that the Fed will, at some point, begin to sell its holdings into the market. Promising to let these assets simply run off as they mature and using other tools to manage excess reserves in the interim may help to persuade market participants that real long-term yields will stay low for the foreseeable future.