August 7, 2007

Special Fed Update

At 2:15 PM EDT today, the most anticipated Federal Reserve policy statement in years will be released. It is widely expected that Bernanke & Co. will leave interest rates unchanged, but their little "pearls of wisdom" has the stock market waiting with baited breath!

In my now 20 years in the business, I don't recall so much hype going into an announcement where everyone already knows the outcome. To be fair, it wasn't until the late 1990s when the Fed actually began releasing a statement. Prior to that, Fed watchers had to gauge their action from publicly available system repo activity until meeting minutes confirmed this weeks later.

The Fed is in a serious quandary. We all know that a credit crunch is developing, the extent of which is still up for debate. We all know there is a serious housing problem. On that alone, the Fed should certainly lean to the easing side.

But is the Fed's job to rescue consumers and institutions who invested in bad instruments? Should the Fed care about bailing out the likes of Bear Stearns et al for the horrible exercise in judgment? To me, the Fed needs to care about a system meltdown, not a short-term blip.

As I have mentioned since late last year, I do not believe the Fed will act to protect the system unless the stock market declined at least 10%. We are not there yet and the market has done an excellent job of digesting the barrage of bad news in July.

On the flip side of easing, Bernanke has often commented that his committee's greatest worry is inflation. We all know energy is at or close to all time highs, yet for some reason, too many people dismiss this as being temporary. Folks, it's been two YEARS and energy remains a significant problem!

The government uses a formula to calculate the consumer price index,CPI. That formula has been changed more than a dozen times in the last 50 years to be less volatile and more "accurate". What they've accomplished is essentially removing any possibility of recognizing real inflation!

Today's CPI is about 3%. If the government used the formula they did in the mid 1990s, that number would be close to 6%! Anyone who drives or eats knows what I mean. That's what makes it so difficult for the Fed to cut rates.

Let's assume the Fed cut rates today 1/4%. The stock market would immediately rally. I mean it would scream higher! The banks, brokers, homebuilders would go vertical. Lending institutions would be able to earn more money and shore up their balance sheets. Great for all?

NO. The bond market would sell off very hard. Gold would skyrocket and the U.S. dollar would completely collapse. Lower rates would make our currency and bonds less attractive around the globe, causing even MORE inflation! That's the predicament Bernanke & Co. faces. Damned if you and damned if you don't!

Bake all of these ingredients into a cake and it comes out with a very bland, no action outcome. The key is going to be exactly what words are used in the statement. Most people expect the Fed to move to a neutral bias and I agree with that.

I am particularly interested to see how Bernanke views inflation and the credit crunch in the same statement. It's impossible to attack both! Will he tip his hat for the next rate move?

I also expect trading in stocks, bonds, commodities and currencies to be extremely volatile after 2:15 right until the close at 4:00. If you are one who likes to trade intra day, I urge you to be very, very careful using market orders as you may be filled at different prices than you imagine. Most good traders will also reduce the size of their trades for the rest of the day to account for the increase in volatility.

Ben Bernanke has done a pretty good job so far as Chairman of the Fed. He has earned a lot of respect and I do not expect him to do anything to change that right now.

Treasury Secretary Paulson should take a page from Bernanke's book in how to carry yourself. In my opinion, Paulson has lost a lot of credibility lately by practically begging the dollar to rally. It seems as though he pounds the table for the dollar in every speech and interview he gives. I seriously wonder if he really believes what he says or is just trying to convince himself!

Finally, sorry to those that received last week's edition with "Thank You" in the subject line. It was my error for not proofing the email to two of our lists.

I hope to send another update in a day or two and discuss the stock market with the myriad of indicators giving strong convictions.

July was one of our best months of 2007 and I am really proud that clients made good money when no one else did and the market collapsed.

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