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Bernanke To Avoid Greenspan Blunder

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The Federal Reserve just began their two day meeting that will wrap up on Wednesday with the "traditional" 2:15 pm announcement. At that time, I expect exactly what Bernanke & Co. has been giving us; strongly hawkish commentary and no interest rate change.

There is much debate now about what the Fed SHOULD do, but to me, it's pretty clear that they would like to stand pat on rates for the foreseeable future. Jawboning the financial markets is a different story. I fully expect Bernanke et al to continue talking "tough" on inflation and warning everyone that they could act.

But let's remember that it's a presidential election year and interest rate hikes and cuts are VERY unusual between now and the election. One of Alan Greenspan's classic blunders (and he had many) was to raise rates and keep them up in 2000 long after the dotcom bubble had imploded.

If you recall, the market was gasping for a rate cut in the 3rd and 4th quarters of 2000, but Greenspan waited until it was too little, too late in early 2001. Thankfully, we have Ben Bernanke at the helm now and so far, he appears to be much more in tune with the markets and less focused on creating his own form of language in front of Congress and the media.
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Could the markets withstand a 1/4% token rate hike now? Absolutely. Even 1/2% isn't the end of the world. But I don't think the Fed is ready for that yet. There are too many economic components teetering and the banking system remains a complete and utter mess!

Are We Headed For An Inflationary Death Spiral?~~~~~~

Inflation has now become the foremost topic on Americans minds. As we learned in the 1970s and early 1980s, the strongest and most effective way to fight it is by quickly raising interest rates. Frankly, it's pretty easy as Paul Volcker, then Fed chairman, taught us. "All" we sacrifice is one or two serious recessions where unemployment spikes to 10%+.

Deflation, however, is the real, long-term economy killer as we learned in the 1930s and Japan experienced in the 1990s and earlier this decade. Very low interest rates for a long period of time are the best measure to correct that, but time is the key. It could take years and possibly a decade to fix!

To me, today's climate may be the toughest for the Fed since the 1930s with all of the economic crosscurrents. When stocks and the credit markets were imploding back in January and Bernanke & Co. aggressively slashed rates again and again while food and energy were spiking, I watched many people question his moves.

But as one of the foremost authorities on the Great Depression, Bernanke knew that inflation could be tamed a whole lot easier than deflation. Remember his comments about dropping money out of helicopters as a cure? And with stocks, credit and housing all in collapse, the risk of DEFLATION far outweighed inflation.

Today, the stock market is clearly not broken, just a bit bruised and battered. Credit is functioning a little better, but by no means back to normal. And housing remains a disaster that's not improving. Energy and food prices have gone vertical, but let's remember that headline inflation is far worse than the core.

Core inflation strips out food and energy since they are supposedly very volatile. In the 1970s, core inflation was worse than the headline number and that's when big problems occur. Right now, we have the opposite. The raw data with food and energy included remains problematic, but the core is more under control. It's this type of inflation that the Fed can "tolerate" for the time being and allow money to stay "cheap".

What would cause Bernanke's hair to stand up on the back of his neck? Wage inflation for sure! That's the primary difference between now and the 1970s. Wages were skyrocketing along with everything else in an inflationary death spiral. Today, you would be hard pressed to find any industries where wages were even in a solid uptrend.

When I speak with friends, clients and colleagues, I hear of lower pay or stable at best. Yes, the price at the pump is obscene and I cannot believe how much our food bill is each week at Stop & Shop. Many items have doubled just this decade.

But folks, we are certainly not in an inflationary spiral. Just look at the internet, which is actually a powerful deflationary force. These companies lack many of the fixed expenses of traditional bricks and mortar entities and pass along some of the savings to us. Wal Mart is a deflationary force! As is computer equipment.

So before swallowing the Kool Aid that this is just like the 1970s, take a step back and look what's around us. We have a "temporary" spike in food and energy that may last a few years on balance. And that is and will continue to hamper our economy with higher unemployment coming. But I do not believe we are in the throes of a hyper inflationary move, like post World War II.

I never thought I would EVER say this publicly, but I applaud the Bernanke led Fed's efforts. And I have since mid January when they finally "got it" after being asleep for too long. And apparently, the bond market does too!

Since the single biggest enemy of bonds is inflation (it eats away at the return), wouldn't you think that if inflation was going to be a serious and long-term problem, the bond market would be in the throes of a secular bear market?

You would be hard pressed to call a 30 year bond yield of 4.71% as worried! And even though yields could and probably will head towards 5.50% and maybe even 6% (gosh no!) or a bit higher in 2009, that's still VERY low historically.

Do you remember 18% money market rates and 15% muni bond yields in the early 80s? Now those were inflationary times!

The big question for you is, how is your portfolio faring in these times and is it positioned properly for what lies ahead?

If you cannot simply and clearly answer that question, please hit "reply" or contact me directly at 203.389.3553 to set up a call or meeting to get my unbiased opinion. As my colleague Larry Bogner likes to say, the consultation is free, but the information is priceless!

In Short...

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To sum it up quickly, the U.S. is not in a great place economically and the Fed is trying its best to balance that seesaw between inflation and deflation ever so gingerly without throwing the economy into a serious recession.

Energy is not done rallying yet and crude oil should see $150 a barrel with $5 a gallon gas in many places sooner than later before the bubble gets pricked. But remember that the final move in commodities is often the most dramatic, like an encore at a Bruce Springsteen concert after a three show!

The short-term remains dicey, but we should see some improvement before the NFL kicks off its season in September.

Finally, as I've been discussing for a few weeks, the stock market is finishing up the pullback it began in mid May and should be complete before we break for Independence Day next week. I firmly believe, and our indicators and models support a much higher market into the summer that exceeds the May peak.

Wall Street is aggressively reducing earnings estimates and lowering expectations, just like they have done historically right before stocks head higher into and through earnings. Volatility will remain high as it's been for almost a year, although we never really get used to it, do we?

Enjoy the rest of your week and I'll be back to you shortly with part III of my piece on energy.

And please don't forget to contact me to discuss how your portfolio is and should be positioned during these truly unique and unsettling times!

Friends And Family Plan

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Finally, as you know, our firm and this newsletter continues to grow mostly from your referrals. If you know anyone who is interested in securing their retirement, planning for it or just plain worried about it, please send them here. As always, thanks for thinking of us with your circle of family and friends.

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