June 6, 2013

Market Insight:
Is Good News Bad News?

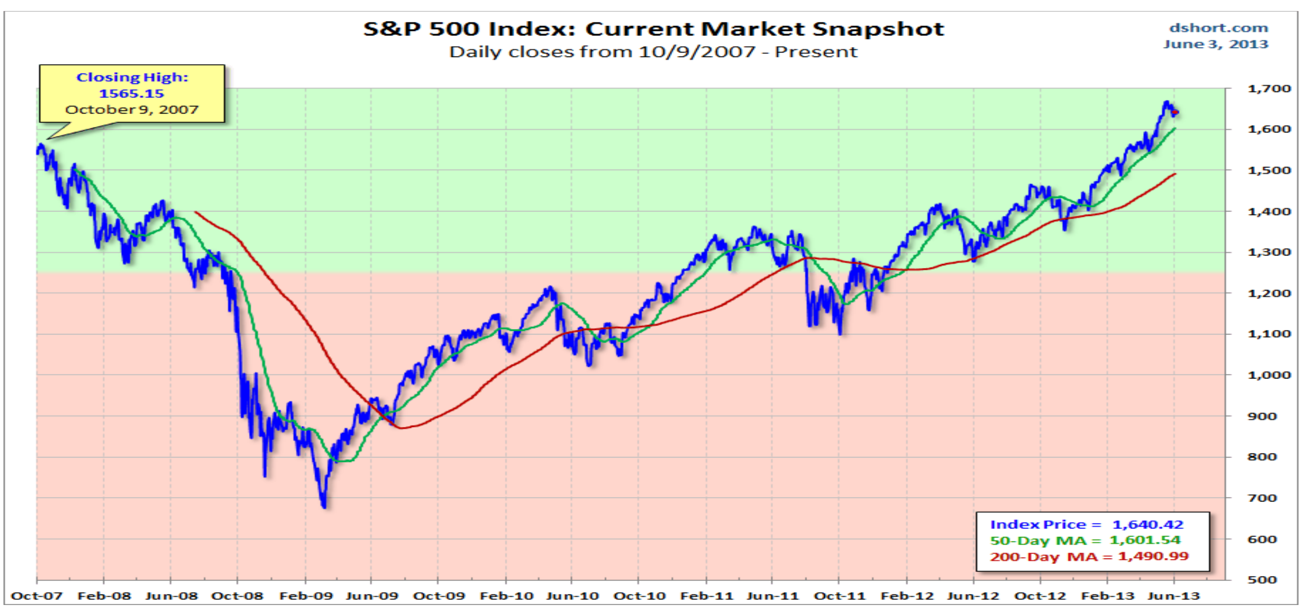
Financial Markets have turned volatile over the last 10 days due to conflicting comments from the Federal Reserve over when and how much reduction in quantitative easing will occur this year. A change in directive would indeed be a big deal; because it means the Fed has confidence the economy can grow on its own. This should be good news, but the markets see it as bad. Why?

Since January, the Fed increased its stimulus, buying $80 billion in US Treasuries each month in an effort to kick the economy into a self-sustaining orbit. The effect of this massive intervention has been clearly seen in rising prices in bonds (pushing long-term mortgage rates to historical lows) and stocks (investors seeking better returns). Rising asset prices has been a big confidence booster to both consumers and companies to spend more, thus giving fuel to growth. The irony here is that the stronger the economic news, the less stimulus is needed from the Fed and less support to financial assets. Thus the argument goes full circle. So the question is: **can both economy and markets rise without the Fed's rocket boosters?**

Key Market Drivers: **Expectation vs. Reality**

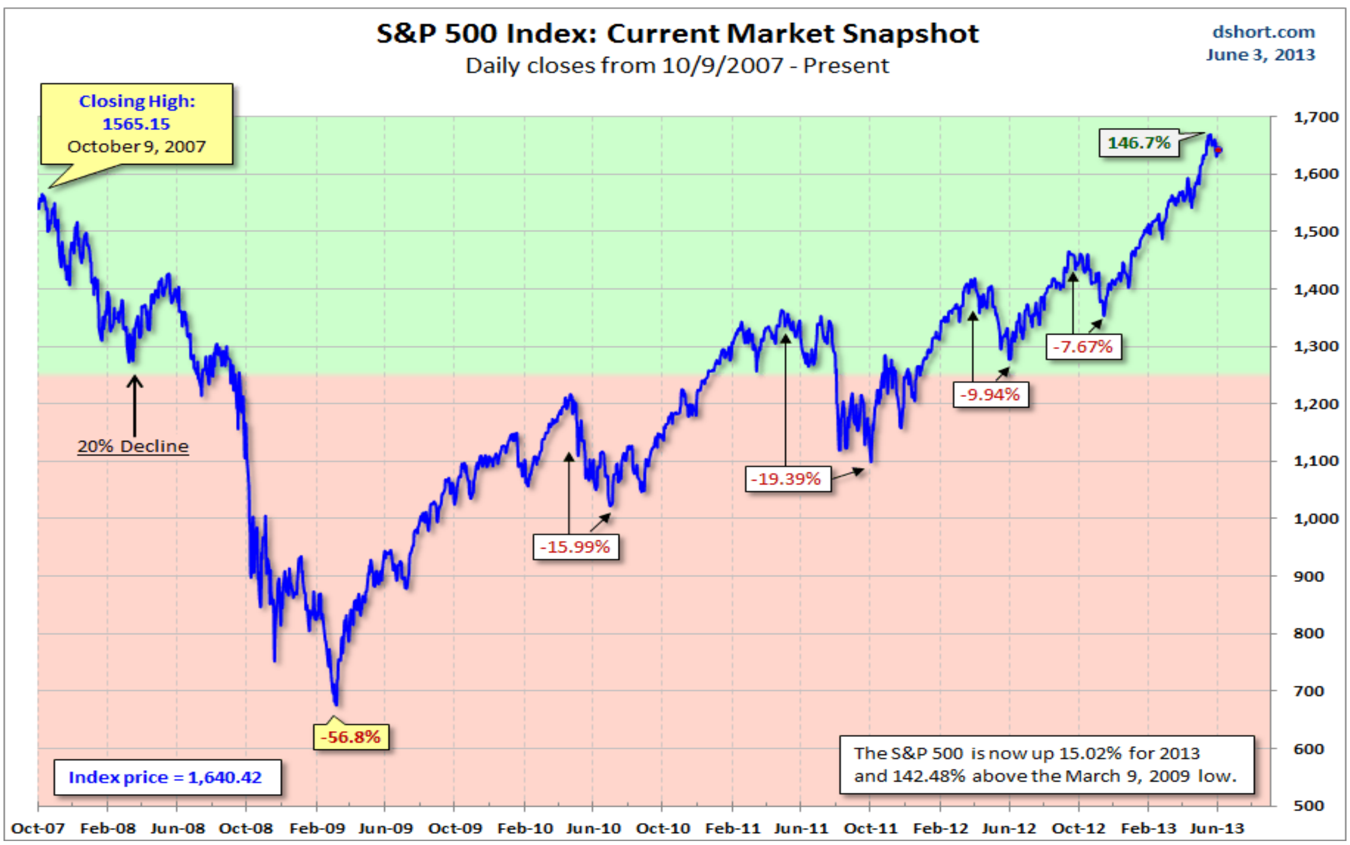
Over the short run (one to three months), investor' expectations can be the driving force for any market. Sentiment alone can easily push prices 6-8% in one direction on the 'hope' or 'fear' of future events. Ultimately though, the fundamentals must line up with expectations, or there is a rapid 'correction' in prices. The two charts below give a good pictorial of this behavior.

The first chart shows the S&P 500 (blue) since 2007 and two moving averages of 50 days (green) and 200 days (red). Because the green line displays short term, it better reflects 'expectations' as compared to the red line, which is long term, better reflects fundamentals. Notice how the green line gets ahead of the red line, both on the down side as well as the up side, but eventually they intersect.



Today is no different. Since the beginning of this year, the market has trended up strongly, reaching all time highs in late May. At that point, short-term expectations (green line) were fueled by confidence in the Fed remaining supportive at least until late 2013 or mid 2014. The market charged ahead, getting well ahead of the long-term economic fundamentals, as evidence of the wide spread between the green and red lines. From a pure technical standpoint, this means, at best, the prices needs to mark-time until the red line catches up and closes the gap, or, prices come down to intersect the red line.

How much could the market correct from the high? In Chart #2 below, shows the S&P 500 but this time with the percentage size of gain off the low (+146%) and size of each correction. Notice how each correction (sell off) is smaller and smaller as the market moves further away from the bottom. There are several reasons for this, but the *main reason is the gargantuan influence the Fed has over the markets.* Since March 2009, the Fed has embarked on an ever-increasing stimulus program, which in turn, has provided liquidity to the markets (blood to the patient) curtailing fears of a crash and fanning confidence back into financial assets. One could argue strongly, that this is all artificial. But the reality is that without any prudent legislative policies, this is the only game in town.



Good News will ultimately be Good News

The next several months, if not quarters, will be a time of digesting the reality that the economy can function with less Fed intervention. In the mean time the markets are likely to chop around in a 3-6% range, until fundamentals and expectations re-align.

Portfolio Positions: Since shifting more into stocks back in February and March, positions have remained unchanged.

As always, please contact me with questions or concerns.

Kind Regards,

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