Market Insight: Markets Rally on Fed Admission Economy Still Very Vulnerable

March 28th 2012

Economic Update:

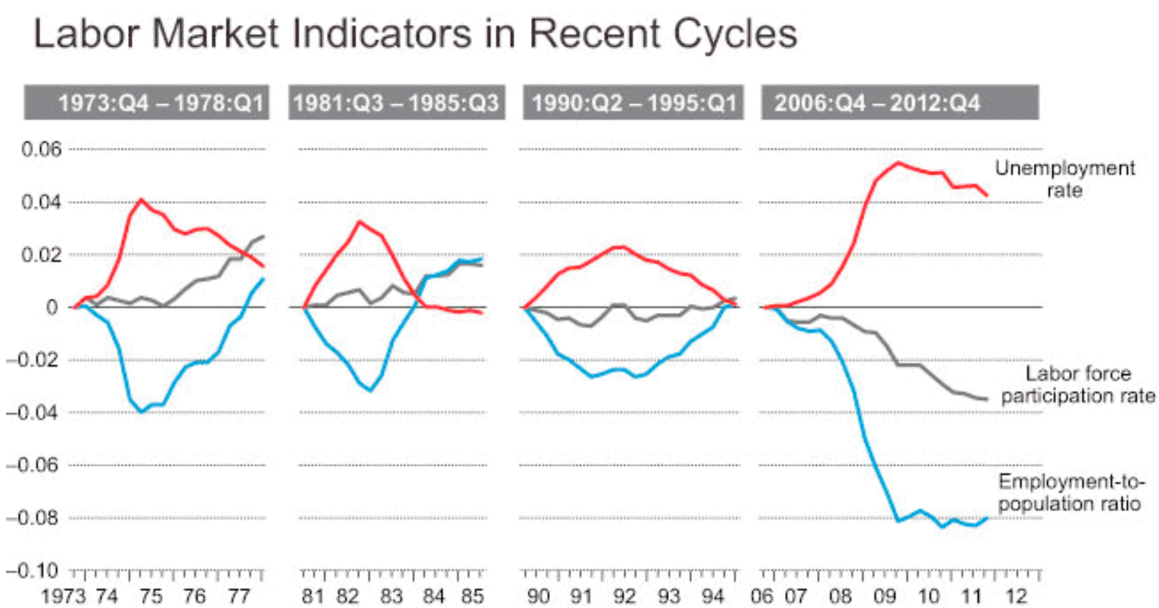
Who is right, the Fed or the Market?

Stocks rallied Monday based on comments by the Fed that more accommodation was needed to insure a solid recovery. One could takeaway that the Fed Chair admitted that the economy remained weak and there has been no significant recovery yet. In relation to job gains, Bernanke specifically stated, "we have not seen (improvement) in a persuasive way yet." He followed up by saying that without much stronger GDP growth, the unemployment rate was unlikely to fall much further.

Essentially, Bernanke's remarks are an admission that the Fed's policy of zero percent interest rates for almost three and a half years now and two rounds of quantitative easing (combined with trillion plus dollar budget deficits for four years in a row) have at best, kept the economy from deteriorating further, and that solid, sustainable growth has yet to occur. The average American however wouldn't know this based on what they read in the papers and hear on TV. There have been three years of reports from the mass media informing the public about the "recovery" that is taking place.

Every time Bernanke has made comments, whether specific or indirect, about more stimulus from the Fed, stocks have rallied strongly — one of the few things that easy money has accomplished. The Fed has also been successful in driving interest rates down, although this seems to be changing. Long-term rates rose slightly on Bernanke's remarks even though the Fed's Operation Twist program is still ongoing. Mortgage rates, after being at all-time lows, rose above 4% last week.

What is Bernanke looking at that makes him still very cautious on the economic outlook? Perhaps it is the picture below which compares the current labor market recovery to previous recoveries and reveals a very weak picture today. Yes, the unemployment rate has decline (red line) but it is mainly due to a drop in the labor participation rate (gray line). As the blue line shows, the actual number of people employed relative to the population, has barely budged. **In other words, a larger share of the population is out of the labor force rather than participating and being unemployed.**



Investment Strategy: It is hard to load the boat up on stocks when you see charts like this and hear the Fed express concerns about the sustainability of the economy. However, in the 30years I have been following the markets the one thing I have learned is 'DON'T FIGHT THE FED'. In this case, if the Fed is going to foster very easy monetary policy by continuing to flood the system with liquidity, money will flow into risk assets like stocks. And currently, traders and investors in general are under-weighted in stocks. These two factors will provide a positive environment for stocks for a while. But eventually, rising stock prices must be supported by rising earnings and sustainable growth.

Risk positions have been increased modestly through more exposure to cyclical sectors and reduction in commodity long/short position.