



Perspectives

A Strategic Update: Why I Expect the Fed to Stay Behind the Curve



Just a few weeks ago, virtually all financial assets were rising—now we're caught in the opposite mode. Bond investors are getting seriously hurt and those who are holding stocks are watching their portfolios melt away. What's to blame? In a nutshell, the strong US economy. The modest growth/no inflation environment that allowed the Federal Reserve to lower interest rates to a four-decade low has ended. US economic growth is now nothing short of robust, while inflation is starting to rev up its engine. By year-end, we could be saddled with the first meaningful price pressures in years.

What financial markets are trying to quantify is how soon and with what vigor the Federal Reserve will ratchet up interest rates. Two weeks ago, consensus thinking was that the Fed would take its sweet time to raise rates. Now, the prevailing view is that the Fed will act sooner and perhaps boldly. In other words, investor sentiment has changed from one extreme to the other, mostly on the basis of two things. One is that the US economy continues to produce at a better rate than anyone expected; the other, that Chairman Greenspan's now openly says that the deflation threat is gone and that interest rates could go up. Anyone who can think independently has understood these realities for weeks, but to the market place they seem to be a revelation.

Coming Rate Hike Likely Cosmetic

The key question, of course, is whether the Fed will act decisively, or whether it will keep behind the curve and do the least necessary. Given what's at stake, I'd be very surprised if the coming hike in the Fed funds rate were more than cosmetic. Consider how a meaningful rate increase would impact the consumer, who's still the mainstay of the US economy, and how it would affect the nascent recovery in capital spending. Then there's the export sector, one of the bright spots of the current recovery. US exporters are already eyeing the dollar rally nervously; much additional strength in the currency would hurt. Consider also that the Fed will want to treat this economy with kid gloves, because oil prices remain perilously high, Europe's economy is starting to sputter again, and --last but not least-- because it's an election year. In short, folks, I think the rising interest rate specter is overblown!

If I'm right and the Fed stays soft, there are several consequences:

Bond prices will snap back, as fears for a serious rise in interest rates recede. But don't be fooled. A continuously lax Fed policy will further erode the fundamentals for bonds. I still believe that fixed income instruments are in for a nasty surprise and that the free market will eventually do what the Fed won't—force interest rates higher. Treasuries, in particular, are an area I'd stay away from, because cyclical risks from a strengthening economy are augmented by the government's deteriorating balance sheet. For those of you who want bonds in their portfolio, I recommend high quality corporate issues with relatively short maturities.

The economy and corporate earnings will benefit from continued Fed neglect. The eventual price to the economy will come in the form of inflation, but the next few months should be decent for the stock market. As fears of assertive Fed action prevail, equities are taking a breather--watch for a relief rally when the Fed proves less tough than its rhetoric. Selectivity will remain a key for stock investors. Some sectors will vastly outperform the broad market, while others will stagnate.

The dollar will continue to advance until the Fed shows its true colors, then falter. No one in America is interested in a stronger dollar, especially not in an election year. This is not to say that foreigners won't have a say in the matter, but what I suggest is that both the Fed and the Treasury will do what they can to counteract the dollar's rise. The Bush campaign will join the effort; its success depends on several export-sensitive swing states.

Gold, which has sold off in recent days, will reverse course and continue its rally. The bullion market has weakened under the prospective burden of higher real interest rates in the US. Once this concern lessens, a resumption of the rally is likely. The fact is that real rates in the United States will remain at historically low levels unless the Fed raises rates considerably higher than is expected. Also in gold's favor: highly unstable currency markets, geopolitical turmoil, robust demand thanks to new gold investment products and China, and a steady decrease of forward gold production by producers. I expect gold to make a significant low in May and then regain its luster as we head into summer.

No Change to Strategy

Having read this, many of you will want to ask whether the most recent changes in market perception affect my strategic thinking. The answer is no. I believe my overall strategy and the model portfolio are just the way they should be. □

Publisher: Cavelti & Associates Ltd., Toronto, Canada.

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