

The Week

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Unusually uncertain outlook

- Last week Fed Chairman Bernanke testified before Congress, giving his twice-a-year update on the economy and monetary policy.
- The Fed Chairman said that the economy is likely to grow at a moderate rate, and the Fed would keep interest rates low for an extended period.
- However, the markets initially disliked his message, particularly his characterization of the outlook as unusually uncertain.

If you are worried and suffering from emotional problems, you may go to a therapist for advice and reassurance. You want to hear the therapist say that everything will be fine. You don't want to hear him or her exclaim, "Wow! You've got big problems!" Unfortunately, that's what many people thought they heard Fed Chairman Bernanke say when he testified last week.

Investors are concerned that the economy is slowing down and worried that the economy might fall back into recession. They wanted Chairman Bernanke to say that the economy is healthy, and there are no major issues with the recovery. Instead, Mr. Bernanke explained that the economy is doing better than during the financial crisis, but there are still many problems to overcome. Consequently, there is unusual uncertainty for this point in the economic cycle.

By the end of the day, the stock market had dropped sharply because more investors interpreted his comments negatively than interpreted them positively. However, a thorough reading of his statement shows that the Fed Chairman is not pessimistic about economic prospects. In fact, the Fed is forecasting the economy to grow by more than 3% this year with slightly faster growth next year. This positive view was overlooked by investors who were disappointed that the Fed Chairman did not give an "All's-Well" testimony.

Many investors already know that this is an unusually uncertain period. The economy is not going through a typical economic cycle. The financial crisis of 2008 was the worst since the Great Depression. Housing continues to be depressed with mortgage foreclosures at record high levels. Unemployment is still high and the average length of time that someone is out of work is also at the highest level in the modern era. Therefore, some widely followed market pundits are very negative. At the same time, other analysts are very positive because corporate profits are rebounding, despite all these problems. In addition, the global economy is being fueled by stronger growth in emerging markets. This is increasing the demand for tradable U.S. goods and services. Moreover, the credit markets are functioning better and many companies have built up large cash reserves in order to weather current problems. Most important, companies are buying new equipment and are starting to hire workers again.

With this mix of negative and positive factors, it is no wonder that the Fed Chairman is saying that economic conditions are unusually uncertain. Nonetheless, when questioned, Mr. Bernanke repeated several times that the Fed believes the most likely scenario is for continued modest economic growth not another recession.

During his first day of testimony, many of the questions were directed toward Fed policy. In particular, senators asked whether the Fed had any other tools to help the economy if economic conditions deteriorated further. In other words, several senators were worried that the Fed was out of bullets and could not do anything if the economy faltered.

Mr. Bernanke said that the Fed had the tools, but did not promise to provide further stimulus to help the economy. In fact, the Fed Chairman discussed how the Fed might start to remove its current easy money policies in the future. Once again, this did not set well with investors who wanted reassuring words that the Fed was already doing more to help the economy.

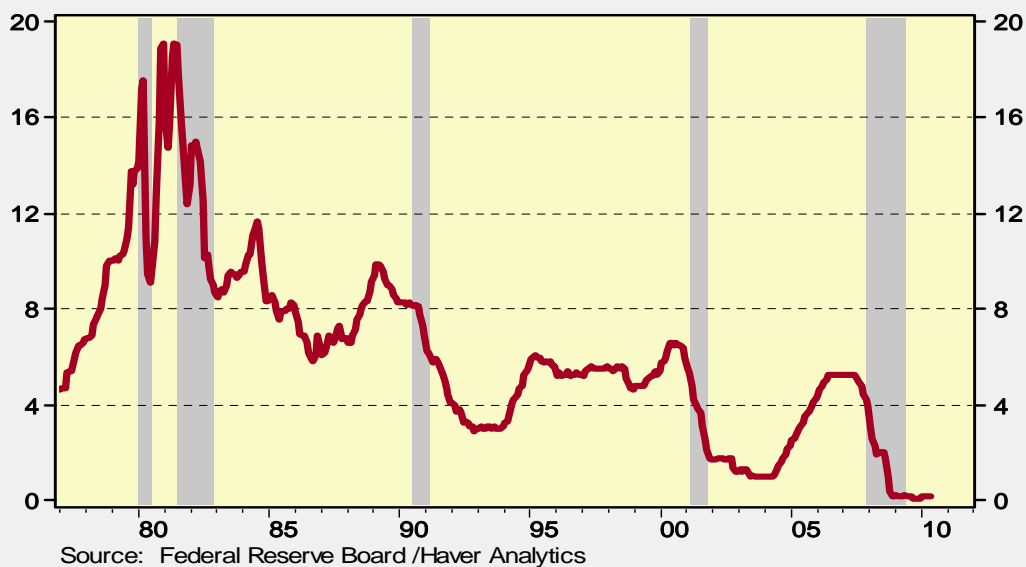
The good news is the market responded positively to Chairman Bernanke’s second day of testimony and closed the week at the best level in a month. Of course, good earnings numbers and the results of the European bank stress tests also helped lift investors’ spirits a bit.

It would be nice if the economic news was strong and the only problem with the market was negative sentiment. Unfortunately, recent economic news has been much softer than earlier this year. The economy is clearly slowing down. That does not mean that another recession is starting. Rather, it appears that the economy is going through a normal slowdown that often occurs after the first year of recovery. If there are no major shocks to the economy during this period, the slowdown is likely to be just a temporary pause in activity before growth resumes at a more normal pace. Our forecast for the economy is not quite as positive as the Fed’s because we are concerned about high unemployment this year and higher taxes next year. Nevertheless, we agree that the most likely scenario is for further economic growth not another recession.

Looking ahead, we continue to expect equities to be volatile during the next few months. It may take more time for the market to work off the excess of the 80% gain in the S&P 500 during the 13-month rally from March 2009 through April 2010. Longer-term, we continue to believe that the market is likely to move higher into early 2011 as the economy works through its problems. The biggest risk to the downside would be any unexpected event that would derail business and consumer sentiment, causing spending to contract again.

INVESTORS NOW EXPECT THE FED TO KEEP RATES LOW UNTIL MID-2011

FEDERAL FUNDS INTEREST RATE
Percent



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