Federal Reserve Bank Chairman Bernanke surprised markets during his post-FOMC meeting remarks yesterday – why? Some of the reaction is due entirely to the ad hoc introduction of quantitative easing (QE) in its various forms without thought for the net result or end-game.

He delivered a message that was far less dovish than many expected, and this for good reason – the U.S. economy is in far better shape than he and his team had been forecasting these past months. This is where the ‘market conflict’ arises: i) growth really should be good for America and the U.S. stock markets but ii) equity participants are weary as to what might happen as Fed ‘tapering’ begins. Tapering is the in vogue term for the Fed beginning to reduce the size of their asset purchases (do keep in mind, however, that tapering is still easing as opposed to tightening).

We are of the opinion that the real threat to continued U.S. economic growth is interest rates moving higher at an accelerated rate. The 10-year Treasury yield has screamed up this week to 2.43% but we are hopeful that this pattern will not continue and will, therefore, not inhibit the economy.

The lesson to be learnt is that central planners (perhaps with the best of intentions) are never in total control and should not attempt to drive financial markets and particular asset classes in one direction or another.

Higher Volatility, slower & less predictable growth, more uncertainty – UNINTENDED CONSEQUENCES!!
FOMC Meeting Concludes

The Federal Reserve Bank’s Open Market Committee (FOMC) continues to do its best to debauch the dollar and talk interest rates down. In their post-meeting statement it was clear that:

1) Quantitative easing will continue at an unchanged pace (i.e. the purchase of $85 billion of paper per month) until they have more certainty with regards to employment gains.

2) Short-term rates will remain unchanged as long as the unemployment rate remains above 6.5% (presently 7.6%) and inflation remains below their target rate of 2.5% for the 1 to 2 year period.

3) They determined that the economy grew at “a modest pace during the first half of the year” when previously they described it growing at a “moderate pace”. This morning’s 2nd quarter GDP report showed that the economy grew at +1.7% from the 2nd quarter of 2012, beating expectations of +1.0%

Market Reaction:

1) Prior to the FOMC’s statement we had seen 10-year Treasury yields higher at 2.69% and post statement they drifted down to 2.60%. We remain skeptical that The Fed will be able to keep the long-end of the curve down; we expect 10 and 30 year rates to rise over the coming weeks and months.

2) Major equity market indices rose post the statement. We continue to believe that U.S. equities will continue to rise in the foreseeable future.

Might it not be prudent for The Fed to begin exiting its role as a central planner given the continued improvement in macro data releases – just saying!