

HERE WE GO AGAIN!
03/26/07

It looks as if the inflationists have taken over the financial market—for now. How long it will last, we have no idea. This scenario is just the opposite of what we believe will be the ultimate outcome. The announcement last Wednesday that the Fed left the federal funds rate unchanged was not the important thing as far as the markets were concerned. Rather, it was the clear indication that the economy was not acting as well as it should. The next day it was announced that the leading economic indicators were down in February. To boot, January's indicators were also revised downward. Perhaps it has finally dawned upon market participants that the economy is in or near a recession. That being the case, one would expect bond prices to move upward and stocks down. But that did not happen.

It appears that the move of the Fed to being more concerned with the economy rather than inflation has ignited the idea that the Fed will soon ease short-term interest rates. We agree with that, but the market goes on to believe that by so doing they will immediately expand the economy like in 2002. If that is true, then profits will move upward in a year or so, and inflation will again become a problem. In other words, the market has bought into the omnipotence of the Federal Reserve. That is, the lowering of rates will prevent recessions and guarantee prosperity. In other words, recession or not, inflation and interest rates must move upward. Either way, it emphasizes the box in which the Fed finds itself. In the modern equity-oriented Goldilocks outlook, all things point to higher stock prices, regardless of the news; however, keep in mind higher interest rates could turn a recession into something much worse.

Inflation, then, is the major worry concerning the marketplace. It will, before long, become one of the greatest surprises in modern history when deflation rears its ugly head.
Be prepared!