

Market Outlook:

Necessary evil

Once again, the topic of *interest rates*.....more specifically, when or if the Federal Reserve Board will move to raise interest rates....surfaced last week. (Did the subject really ever go away?) Interestingly, the conversation arose because of several economic reports emanating from China showing that key third quarter earnings reports from that region were "slowing". Thus, the tone was set early last week for US stock investors to recoil in fear while the bond markets sat back on the sidelines paralyzed by inertia.

That any of these data would be a surprise to the market is baffling, considering most economists, analysts, and traders had already factored in China's slowdown, not to mention anticipating rate reversals suggested either by market forces or treasuries. Either way, we know that a rate hike is coming.

Following the patterns set in previous weeks, the equity markets then rallied after the "bad news" had been digested and deemed really to be of little consequence. In fact, upon closer inspection, US Gross Domestic Product (GDP) and S&P equity earnings reports actually mirrored an improvement in retail conditions. If the markets had been paying attention, we danced to this tune a mere five weeks ago with much the same level of turmoil.

While my research doesn't believe there is much to fear from a secular reversal (upwards) in interest rates, its occurrence is nevertheless revealing about other supplementary factors which either respond to, or cause, rate fluctuations.

Why wait?

By definition, money must flow somewhere. When the economy is growing, as we are doing today, surplus cash chases after goods and services. Obviously, if demand is sufficient, then prices for those services would begin to rise, precipitating the possibility of inflation. Last week's economic and earnings releases reinforced a steady drumbeat of positive news, both for retail and corporate investors, modest inflation notwithstanding. What we did notice, though, is that spending patterns in discretionary trophy items like artwork, boats, cars, and jewelry are robust in the province of the ultra-wealthy. They have the funds, and the desire to deploy them.

But we cannot ignore seemingly "hidden" price creep in day-to-day items that are also in high demand. Pharmaceuticals, clothing, commutation (bridges and tolls), foodstuffs, education.....even an all-day Disney theme park pass..... are all rising in price at a rate which seems to confound the inflation naysayers. The latest Consumer Price Index (CPI) data shows that both input costs (core commodities) and output (retail price) costs are rising consistently, albeit not irrationally, in tandem. The great equilibrium trade-off is that wages, too, are rising for the first time in a decade.

Thus, the Fed's worry will be that if these expenses appear to be mounting indiscriminately and with an unrestrained trajectory, then the market might be caught in a price spiral that could derail the recovery. Which is also why the market obsesses and responds with such fervor whenever this subject matter is brought up.

The Fed would like to nip these frenzied debates in the bud, but worries at the same time that the consequences of early action might be worse than the consequences of action at a later date. Indeed, they do not want to *prevent* people from borrowing and spending, nor to inhibit capital flow. Rather, and to their credit, they remain diligent about the psychological impact of any action they might take.

The correct decision, I believe, is to initiate a rate hike sooner rather than later, and to eliminate the "noise" that is dominating the conversation. The truth is, as stated earlier, we all know what's coming. **The false perception under which the financial markets are operating is that money will forever remain "free", and that negative consequences would never occur, because the Fed stands ready to deploy its tools as a safety net when called upon.**

Despite interest rates being very low currently, global stock markets have shown that they are susceptible to panic attacks and extreme negative reactions. By allowing that psychological insecurity to build up, without providing for a suitable fixed income alternative to buying stocks, the Fed only *increases* the likelihood that they might be called upon to act as a pre-emptive policeman at some point in the future. They need to *now* what is necessary, and anticipated, and to remind all of us...as well as themselves...that you cannot control the future, but you can control the measures one takes which impact upon it.

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