Investment Watch

3^{rd} Quarter, 2010

"Unusually Uncertain"

US Federal Reserve Chairman Ben Bernanke is not just uncertain these days, he's ***"unusually uncertain"*** and with good reason. In this world of apparent contradictions these days are not only odd, they may prove historic. Some of these uncertainties are familiar, but many of them are new and unfamiliar. Times of transition create imbalances and uncertainties. The world's evolution by integration continues unimpeded but the US, along with other developed countries, is still struggling mired within fragile recoveries.

Unprecedented financial stimulus unleashed by our Federal Reserve, along with major central banks around the world, was necessary to avoid financial collapse in the Fall of '08. But this enormous deficit spending and the ensuing easy monetary policy has created much of today's global economic imbalance.

Growth or Double-Dip Recession?

A couple weeks ago the National Bureau of Economic Research officially declared June '09 as the end of The Great Recession which began in December '07. Lasting 18 months makes the Great Recession the longest since the Depression and it was also the deepest. The subsequent positive growth has been a result of government stimulus and most economists agree we need US business and the consumer to restore economic health. As the Fed indicated our economy is "*constrained by high unemployment, modest income growth, lower housing wealth, and tight credit*."

Most prognosticators agree the economy has not transitioned well from the crutch of government stimulus to standing on its own. But they also agree that there are pockets of sufficient growth to avoid another downturn which would cause a double-dip recession. The economy will not regain its health until jobs are created and the Toxic Asset Waste created by the subprime mortgage meltdown is cleaned up which will loosen credit lines. But it's going to take a very long time to replace the **8 million jobs lost** during the recession and also a very long time to repair our nation's financial system, as last week's Wall Street Journal's headline, **"Banks Keep Failing, No End in Sight"** maintained.

Inflation or Deflation?

Way back in December '08, the Fed cut interest rates to virtually zero to avoid financial collapse and flooded the economy with liquidity. Largely symbolic but nonetheless nearly free, rather than easy money. A nascent recovery, embryonic job growth, and an impaired financial system have forced the Fed to maintain this near-zero "*exceptionally low levels of the federal funds rate"* for almost two years and this will continue "*...for an extended period ."* The Fed Chairman, "Helicopter Ben" Bernanke, got his nickname for advocating easy money policies. The record near-zero fed funds rate was the major tool to unfreeze credit markets. Bernanke told Congress that these are "***unusually uncertain***" times which may require "*unconventional measures*" but also he confessed that he doesn't yet know what those measures will be. So for now he's standing pat, dishing our words and question marks rather than dollars.

This easy money policy has driven down most interest rates to very low levels. Last Monday, the two-year Treasury Note sold at an all-time record low yield of 0.441%, yes that's less than ½%! Low interest rates are linked with subdued inflation which has been running just under 1%. The uncertainty is obvious when money invested in short term treasuries will have a negative real return, that is the total return is less than inflation. This makes the Fed worry about deflation. If uncertainty is driving investors to government bonds, outright fear is evident in gold market. Macro economic uncertainties, the prospect of more Fed stimulus, and a declining dollar are pushing gold to record highs even in the face of very low inflation.

Bull or Bear?

In the 2^{nd} quarter, economic growth slowed from 3.7% to 1.7% and the stock market similarly slumped. During the 3^{rd} quarter a Reuters poll of 70 economists forecast a meager 1.8% growth and 2.1% for the 4^{th} quarter, much less than previous expectations. But the stock market not only avoided its usual September swoon, but rather was buoyed by the best September since 1939, finishing the quarter up over 10%. Thus creating its own set of perplexities, but certainly no complaints.

If the economy continues to soften, validating Reuter's predictions for meager growth, "Helicopter Ben" is prepared to inject additional stimulus using "*unconventional measures*" and start tossing dollars instead of words. Most likely The Fed will print money to purchase intermediate and longer term Treasuries which will hold down interest rates, loosen credit, suppress mortgage rates and further weaken the already falling dollar. Unprecedented actions for unprecedented, "***unusually uncertain***" times. Hold on to your hats, he's taking off!

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