



CROFT
FINANCIAL
GROUP

INVESTMENT COUNSELLORS-PORTFOLIO MANAGERS

Clawing back lost ground

Markets unfazed by Fed's move

February 19, 2010 – Over the past few weeks, the US Federal Reserve Board had done everything but give the precise day, hour, and minute of a hike in the discount rate. Turns out that day was last Thursday, when the Fed raised its so-called “discount rate” (the rate it charges to banks for direct loans) to 0.75% from 0.50%. The Fed had long telegraphed that it was embarking on a mission to “normalize” its bank lending facilities in order to wean banks from the teat of ultra-easy government credit and stimulate more normal credit flows among banks themselves. Though still below the normal average 100 basis point spread over the federal funds rate, the Fed’s move signals its resolve to begin stanching the massive liquidity flow it used to bail out the financial system over the past 18 months.

Immediately following the move, stock markets slipped, while US Treasury prices dropped and the greenback strengthened. To quell fears about an imminent hike in the benchmark federal funds rate (which is used to set short-term rates in the wider economy), the Fed reiterated that its outlook remains pretty much the same as it was in January – that is, that economic conditions warrant keeping the federal funds rate at “exceptionally low” levels “for an extended period.” And speaking after the move, assorted regional Fed presidents all sang from the same songbook, saying essentially that raising the discount rate was a technical move and that monetary policy would remain accommodative to support the fragile recovery.

In what may or may not have been coincidence, the Fed’s move to close the discount window just a notch came hard on the heels of fresh price reports that US wholesale prices increased 1.4% in January, or 4.6% over a year. But a report on Friday showed that US consumer prices remained relatively subdued in January, climbing at an annual rate of 2.6%. Core prices, stripped of food and energy components, rose an annual 1.6%, still below what is widely believed to be the Fed’s inflation target of 2% (unlike the Bank of Canada and several other central banks, the Fed does not explicitly target an inflation rate in setting its benchmark lending rate).

Another hike in the discount rate could come sooner rather than later, possibly as early as April. Anytime after that the Fed is likely to raise the fed funds rate. The reason: The economic recovery is slowly gaining momentum. And while longer-term inflationary trends still seem quite subdued, the shorter-term shows a troubling trend of growing price

increases – US wholesale prices have risen at an annualized 9.8% over the past six months. Although employment remains moribund, factory production rose 0.9% in January and housing starts jumped 2.8%. The 0.9% growth in the production of business equipment especially implies a growing trend in business spending, following a 13% surge in the fourth quarter of 2009. The steady rise in the Institute for Supply Management’s manufacturing index – February’s reading of 58.4 was the highest since August 2004 – confirms an increasingly sustainable recovery. Capacity utilization (the percentage of industrial capacity in use compared to the amount available) rose to 72.6% in January, up from 71.9% in December, and ahead considerably from a low of 68.3% last June. The historic average is 80%.

Employment trends are lagging indicators and typically continue to show weakness for several months after a recovery has taken hold. They cannot therefore be used as a reliable signpost for economic growth trends (although they do confirm trends already in place) or for central bank rate moves. But business spending and manufacturing activity are a lot more immediate, as are price moves, especially at the wholesale level. All in all, first-quarter growth is shaping up to be stronger than anticipated – possibly stronger than even than the 5.7% recorded in the fourth quarter – and you can be sure the Fed will be watching all those early indicators like a hawk. Its “extended period” of near-zero interest rate policy may be telescoped dramatically before the end of the second quarter.

In Canada, the consumer price index rose at an annual rate of 1.9%. The core rate, however, rose to 2.0%, the mid-point target set by the Bank of Canada. It’s not a cause for concern yet, as there is still plenty of slack in the economy. Also, the year-over-year measure seems dramatic because prices actually fell in January 2009.

In addition, last week the government moved to tighten mortgage lending rules in an effort to squelch what it saw as a real estate bubble engendered by a combination of low rates and speculative activity made possible by the wide availability of risky government-backed high-ratio mortgages (pretty much what happened south of the border when the entire government-mandated sub-prime mortgage market collapsed and cascaded into the worst global financial crisis in decades).

Still, the housing market is a key driver of economic growth in Canada right now and may yet expand into bubble territory as eager homebuyers attempt an end run against the inevitable interest rate hike in the second half of the year at the latest. A perceived real estate asset bubble or a spike in inflation could well advance the Bank of Canada’s plans to begin “normalizing” rates.

Stock markets remained largely unfazed by the Fed’s move to raise the discount rate, seeing it as confirmation of recovery. The eurozone problem with Greek debt also temporarily got put on the back burner as investors appeared to focus more on the increasingly bright growth prospects for the North American economies.

As a consequence, the S&P/TSX Composite Index advanced 2.1% on the week, its third consecutive higher weekly close, following the January losses. Similarly, the Dow Jones

Industrial Average closed up 3% on the week, its second straight weekly gain, while the S&P 500 Composite Index gained 3.2% on the week. The big US equity indexes have clawed back only about half the ground lost in January, Canada's benchmark somewhat more.

A mountain of sidelined cash is starting to flow back into equity markets as evidenced by falling money market fund assets. But risk-aversion hasn't quite yet been thrown out the window and any sudden development in international financial markets (unpleasantness in the eurozone, for example) could well result in a sudden reversal of fortune for the stock markets. ■

Please [click here](#) to visit our website for more timely information on the markets, financial planning, and new products from R.N. Croft Financial Group Inc.

www.croftgroup.com