

Between a Rock and a Hard Place (Part Deux)

A few weeks ago, I discussed the unenviable position that Ben Bernanke and the Federal Reserve found themselves in. To reiterate, if they raise rates to quell inflation that has been running higher than their parameter, they will support the dollar, and make our debt attractive for foreign purchase. (Which, by the way, foreigners hold 43%.) However, it could be the final stake in the heart of the housing industry, and thus the economy. On the other hand, if they lowered rates, that would be beneficial for housing, and thus, the economy, or so it's perceived. However, it would call into question the Fed's ability and desire to quell inflation, the ultimate problem of all economies. Bad for the dollar, bad for our debt. What was a Fed Chief to do?

One other point. The stock market rally in the Fall of 2006 was predicated primarily on the belief that the economy was doing just fine; housing problems were bottoming, (no one even knew what a sub-prime loan was), and the Federal Reserve would definitely lower interest rates. But as inflation continued at elevated levels, the promise of lower interest rates was called into question, and thus, into the New Year, the market stalled. In fact, on top of Alan Greenspan talking about recession, over 20 sub-prime lenders declaring bankruptcy, and the carry trade beginning to unwind, the market retreated big-time, with 500 and 250 point down-swings.

Here came Ben to the rescue. Solution: Do nothing, as we suggested. Hint at raising rates. Hint at lowering rates. Give everyone something to hang their hats on, and give the hint that if the economy gets into trouble, the Fed will ride to the rescue. Surprise, surprise, Ben did just that, and the market loved him, at least for a day. The market embraced the idea of the cavalry to the rescue with lower rates. The market ignored our debt, the falling dollar, the growing housing crisis, rising unemployment, falling corporate earnings, and Congress's desire for isolationism.

Not addressing the problems head-on, or even ignoring them all-together, does not make them go away.

As the captain of the Titanic said (who I believe was also named Ben), "Don't forget folks, shuffleboard tournament tomorrow at 10:00AM.....Oh that, just a little bump from an iceberg.

Till next time,

Bill

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