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### Fed Watching in Real Time

By Ed Hynes, CFA

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How's that for a market correction? No fun, eh? In the last month we have seen sharp pull-backs in everything from stocks and bonds to metals such as gold, silver and copper. Investors have been shedding their best returning investments, which are in many cases are their riskiest assets.

Since early May, emerging stock markets have fallen 24 percent; gold is off 21 percent and silver down 35 percent, after falling 12% on Tuesday.

Stock markets in developed countries, including the U.S., have not escaped the carnage. The MSCI EAFE index of developed markets outside North America is off 15 percent from its high. In the U.S., as in the rest of the world, smaller stocks have taken the brunt of the fall. Again from the peaks in early May, we have seen the small stocks represented by the Russell 2000 fall over 13 percent; while the S&P 500 and Dow Jones Industrial Average have lost around 7 percent.

Why did the markets correct so violently and what will happen next? One reason for the correction is that prices simply went up too fast. Fast money, from hedge funds to Mom & Pop's around the world, poured money into commodities and international stock markets. For instance, the demand for emerging stock markets pushed prices up 25 percent in the first four months of the year.

The Federal Reserve's ambiguity on the direction of interest rates has aggravated the situation. This uncertainty on the part of the Fed is quite normal, historically. However, it is now coming after an unusual and extended period where the Fed's policy was crystal clear. Add to all of this, a change in the Fed's leadership, and the market has gotten itself into a tizzy.

The key to future developments is the Fed. As one very smart strategist I know says, never ignore the Fed; and investors are heeding this advice.

I think the new Fed Chairman, Ben Bernanke, has been very clear, although many commentators have unfairly criticized him. He told us that the Fed will be watching the economic data to guide their decision-making and that is exactly what they are doing.

One of the big issues for the markets in recent weeks is figuring out the importance of different pieces of data. For instance, after May's unemployment report showed

weakness in the economy, many observers including myself, felt this would cause the Fed to keep rates steady at the June meeting.

Mr. Bernanke, to his credit, was quick to correct our misperception. He pointed out that we were putting too much weight on the wrong data. Economic growth is important and very desirable, but controlling inflation is Job Number One, and inflation numbers are getting worse.

He explained that April's inflation data, measured on a year over year basis is slightly higher than the 1 to 2 percent he would like to see. But, even more disturbing for him, is that inflation is picking up and over the previous 3 months, core inflation had risen at an annual rate of 3.2 percent.

Yesterday's release of May's Consumer Price Index (CPI) is not going to improve Bernanke's comfort level. Core inflation increased 0.3 percent for the third consecutive month and the annualized 3-month growth rate rose to 3.8 percent. After calling April's numbers "unwelcome developments," Bernanke will have to describe May's data in even more unfavorable terms.

How does the Fed attempt to control inflation? It has only a few tools available to it and the most powerful is its control of short-term interest rates. The Fed can raise short-term rates until the economy slows – with the hope that inflation will follow suit. But raising short-term interest rates is a very blunt instrument for controlling inflation and can seriously damage the U.S. and world economy. This reminds me of weekend do-it-yourselfers, who know to bring a hammer to every job, but recognize things have probably gone wrong if they need to use it.

How high do short-term interest rates have to go before inflation is tamed? Since we know interest rates affect the economy with a lag, have the 16 increases in the last two years already been enough? No one knows for sure. Investors will do well to remember the 1970s when President Ford and the Fed decided to "Whip Inflation Now," giving out WIN buttons and raising interest rates; only to find out the economy was already slowing. They then reversed course and lowered rates, starting a period of stagflation characterized by weak economic growth accompanied by high inflation. This time around the Fed will probably error on the side of whipping inflation now.

In summary, I expect markets to be very volatile this summer. In this environment, long-term investors should make sure they are comfortable with their portfolio's asset allocation and avoid the temptation to time market gyrations.

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