

Fed Lays Out Mixed Path Forward

Weekly Financial Review for January 31, 2012

Over the past couple of years at presentations to farmers, I've usually included a slide showing the long-term trend in the prime interest rate. Noting the historically low reading, the headline says there's only one way to go: up.

While that logic still holds true, it appears the Federal Reserve will keep the plate of low rates spinning for a good long while. In its latest statement on monetary policy the central bank said it will keep its target for short-term Federal Funds "at exceptionally low levels" into late 2014. Previously, the Fed's target was mid-2013.

The news, along with the bank's vow to keep "twisting" long-term rates lower, set off a predictable reaction. First, prices on Treasury bonds, which move the opposite of rates, jumped higher. At the same time the dollar plummeted. Finally stocks rallied, taking aim at highs from May 2011.

Yet in the days after the announcement, the direction of all three markets waivered. Part of the blame rests in Europe, where negotiations over restructuring Greek debt dragged on. While the market cheered the move by 25 of the 27 EU countries to agree on new budget controls, investors wondered whether Greece would mend its spendthrift ways, and whether there would be enough money to shore up all the countries that are going to need help in coming months.

Germany remained hardline on both questions, demanding EU veto power over Greek spending and resisting calls to provide more bailout funds. That left the situation still up in the air, where it's been for some two years.

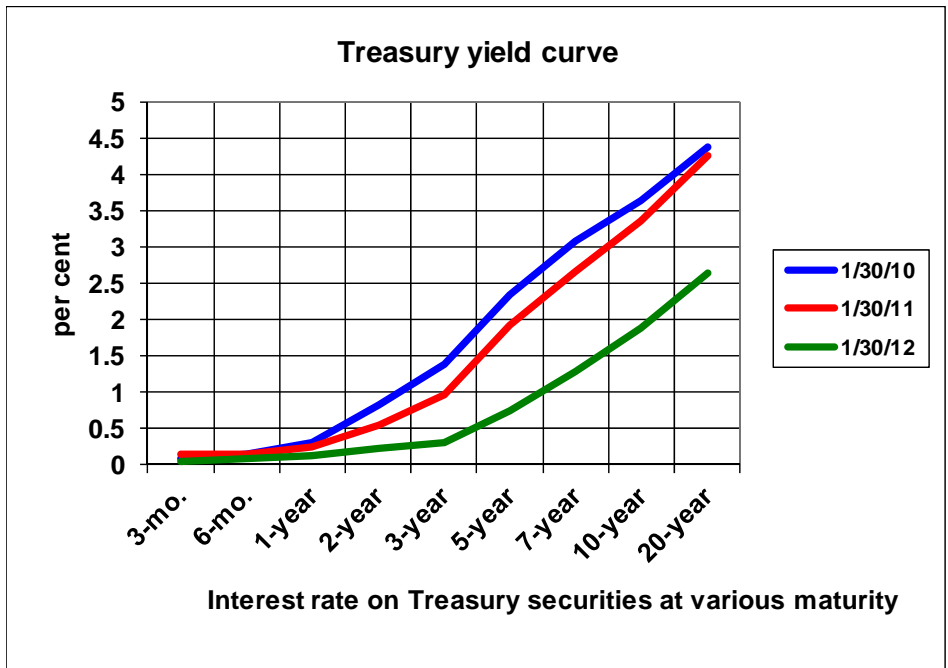
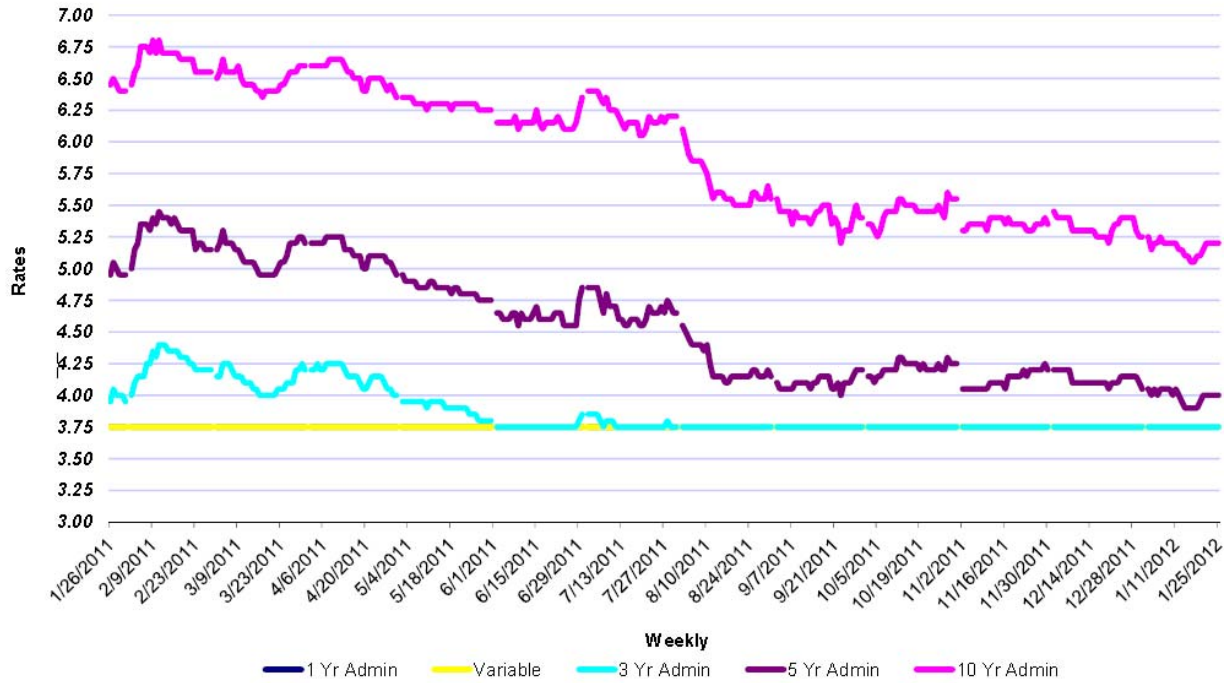
Despite the uncertainty, some money managers believe the euro could still rally more. This line of thinking sees U.S. budget problems returning to the spotlight soon as debate fires up again over extending payroll tax cuts. Uncertainty over the outcome of 2012 elections could also make investors nervous as automatic budget cuts loom in December.

Four factors affect the value of the dollar. High interest rates traditionally attract money to a currency, while deficits do the opposite. Rising economic growth could also attract investors wanting to buy stocks and other assets here. Finally, despite its faults the dollar remains the world's reserve currency. When uncertainty rises, investors still want to own dollars and U.S. Treasuries as a safe haven.

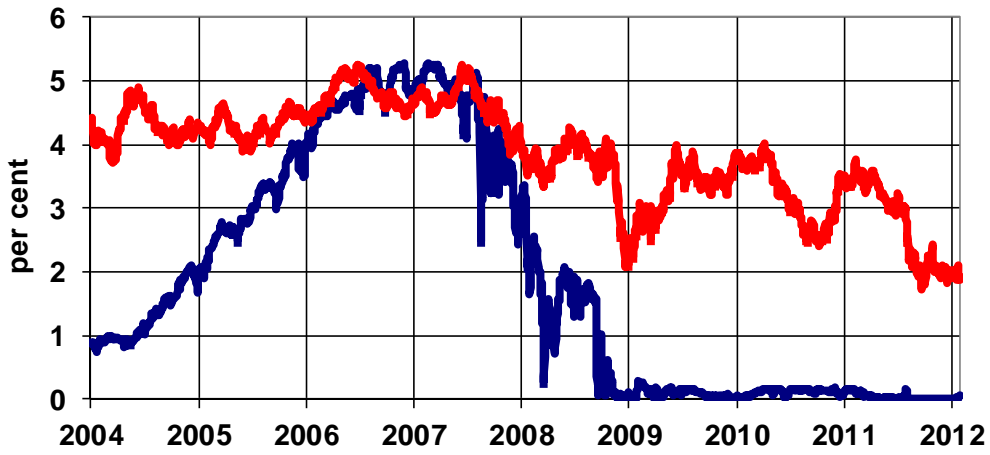
The Fed doesn't get involved in the debate over deficits or currencies – they aren't that crazy. But the bank has a dual mandate: promoting full employment and price stability. Its separate statement on long-term policy last week set an inflation target at 2%. The bank, it should be noted, measures inflation not by the well-known Consumer Price Index, but by the lesser known index of Personal Consumption Expenditures.

The target for full employment is harder to gauge. It changes over time, but is currently thought to be between 5.2% and 6%. That's a long ways from the current rate (which could change Friday) of 8.5%. Fed members don't see this falling fast – their latest projections run from 6.7% to 7.6% by the end of 2014. GDP growth is projected to rise more slowly, reaching 3.3% to 4% over that time frame.

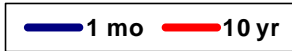
Low interest rates and modest growth should bolster stock prices long-term, presumably helping world demand for commodities, too. That would make the value of the dollar dependent on what happens to the euro, or doesn't. As a result even a long-term rally would likely see plenty of gut-wrenching volatility along the way.



Interest rate spread on Treasuries

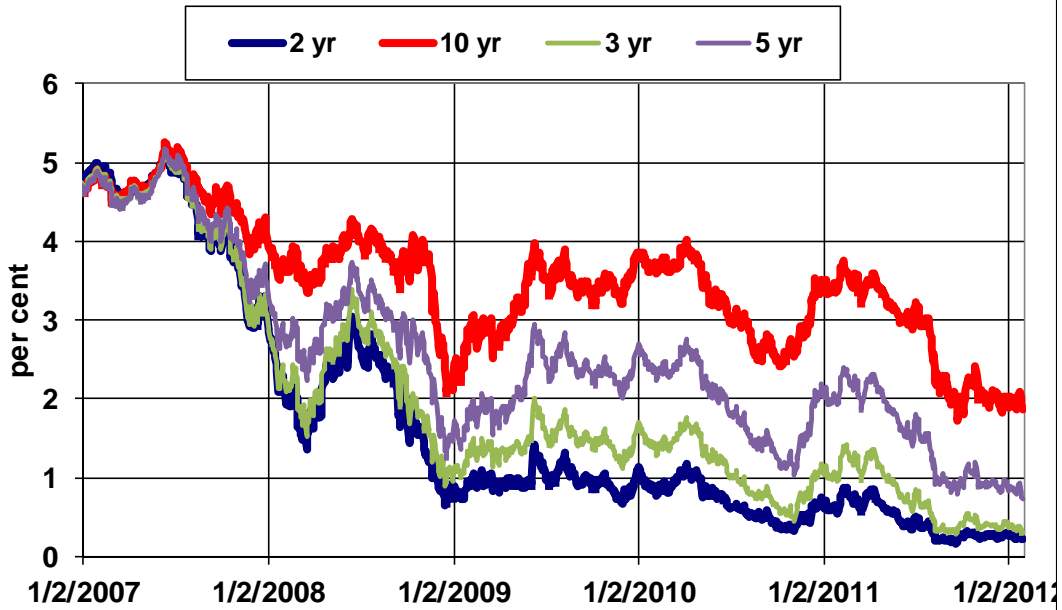


Source: Federal Reserve

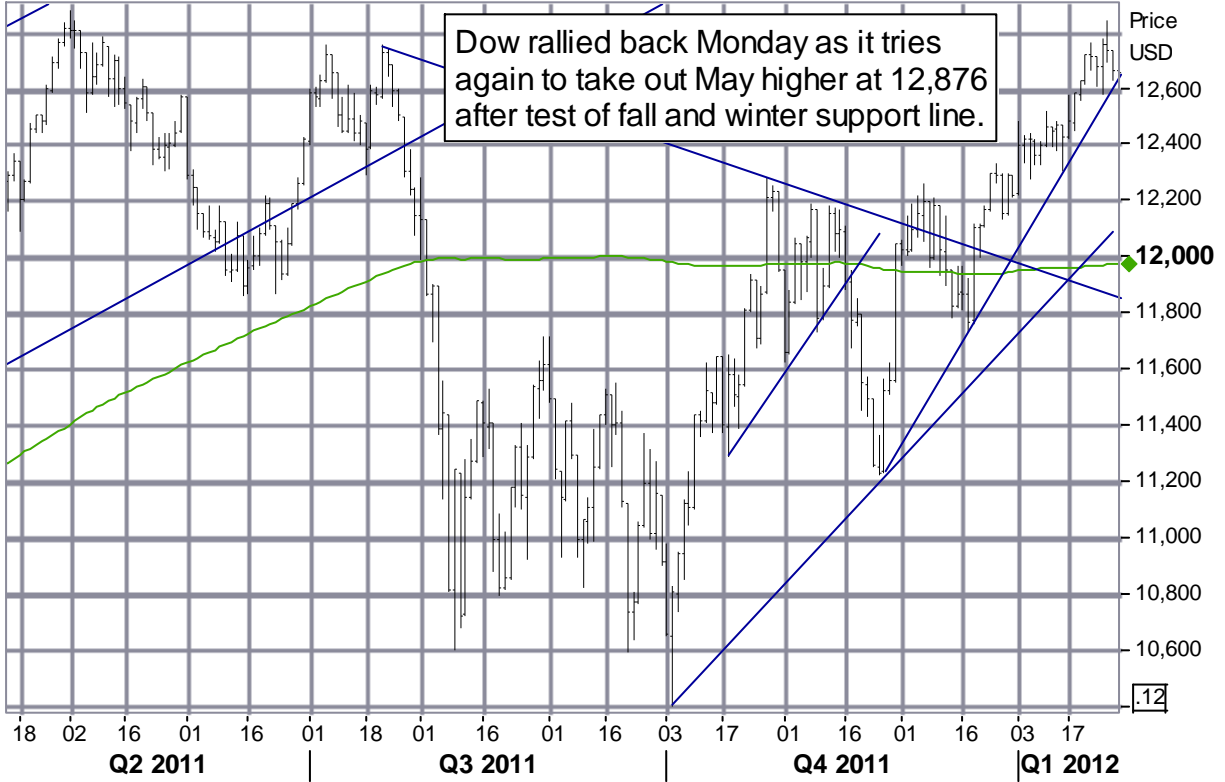


Interest rate spread on Treasuries

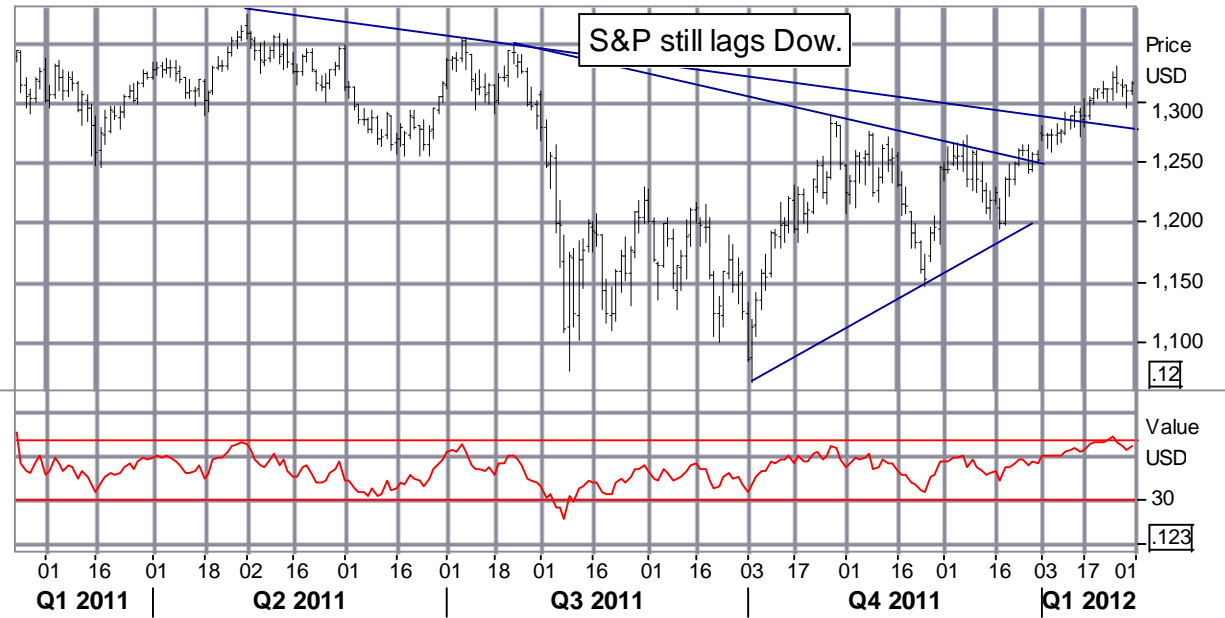
Source: Federal Reserve



Daily Dow Jones Industrial Average

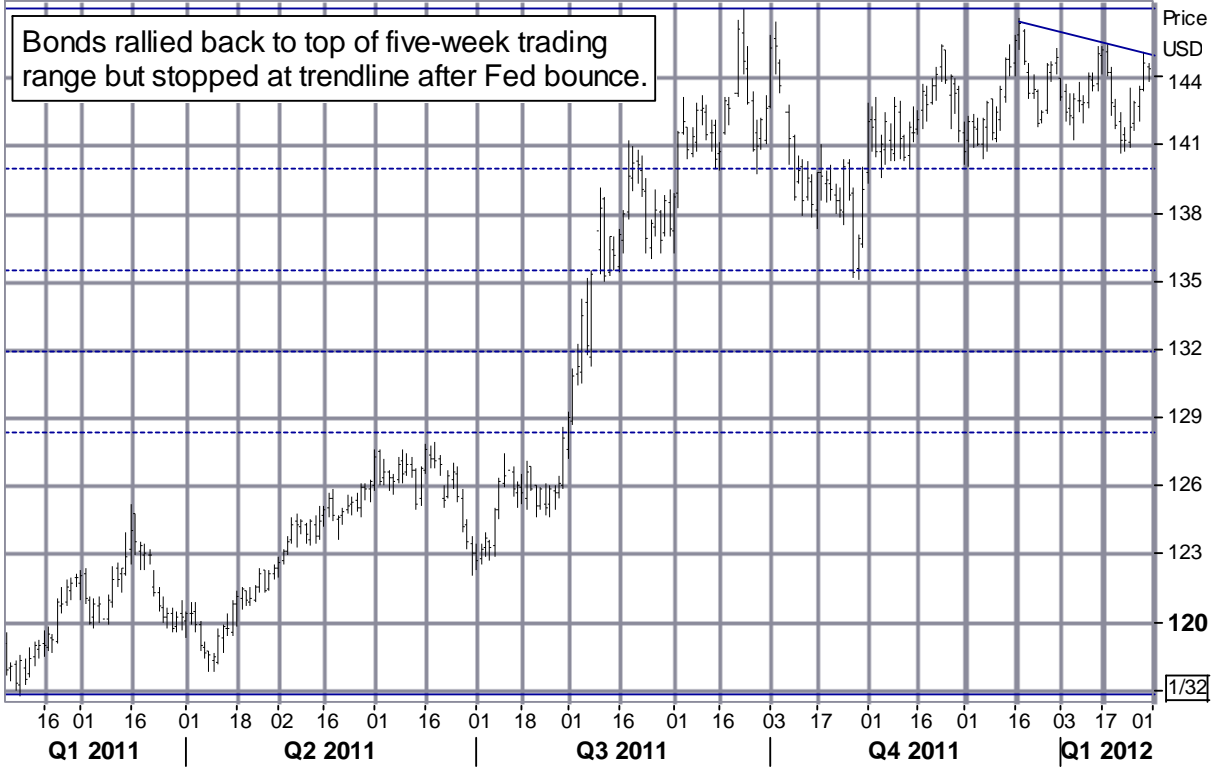


Daily E-Mini



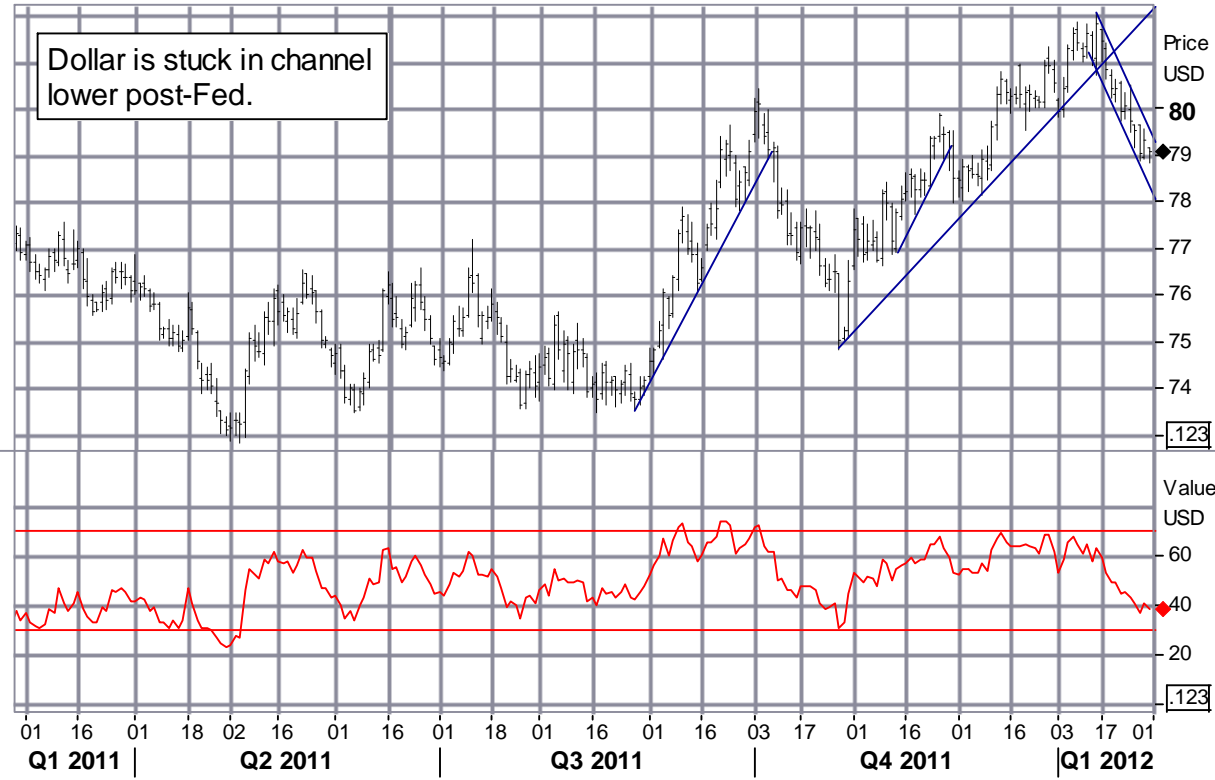
Daily Treasury Bonds

Bonds rallied back to top of five-week trading range but stopped at trendline after Fed bounce.

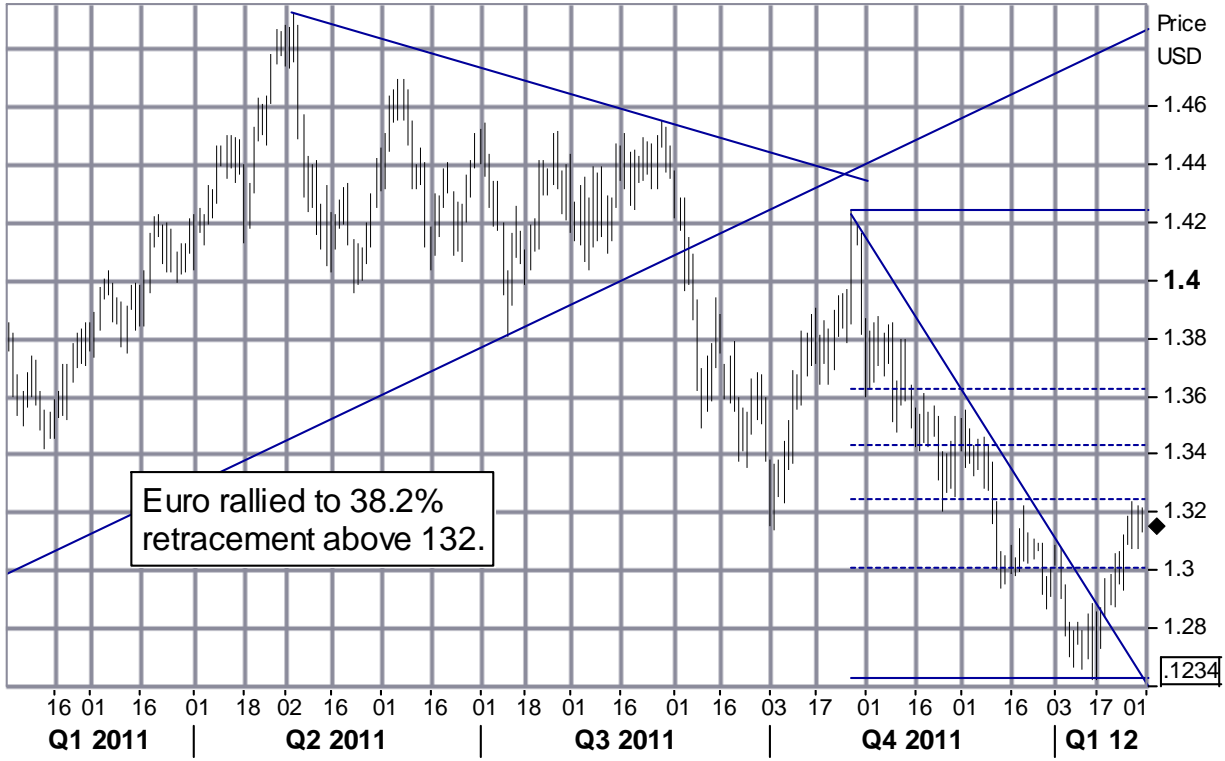


Daily Dollar Index

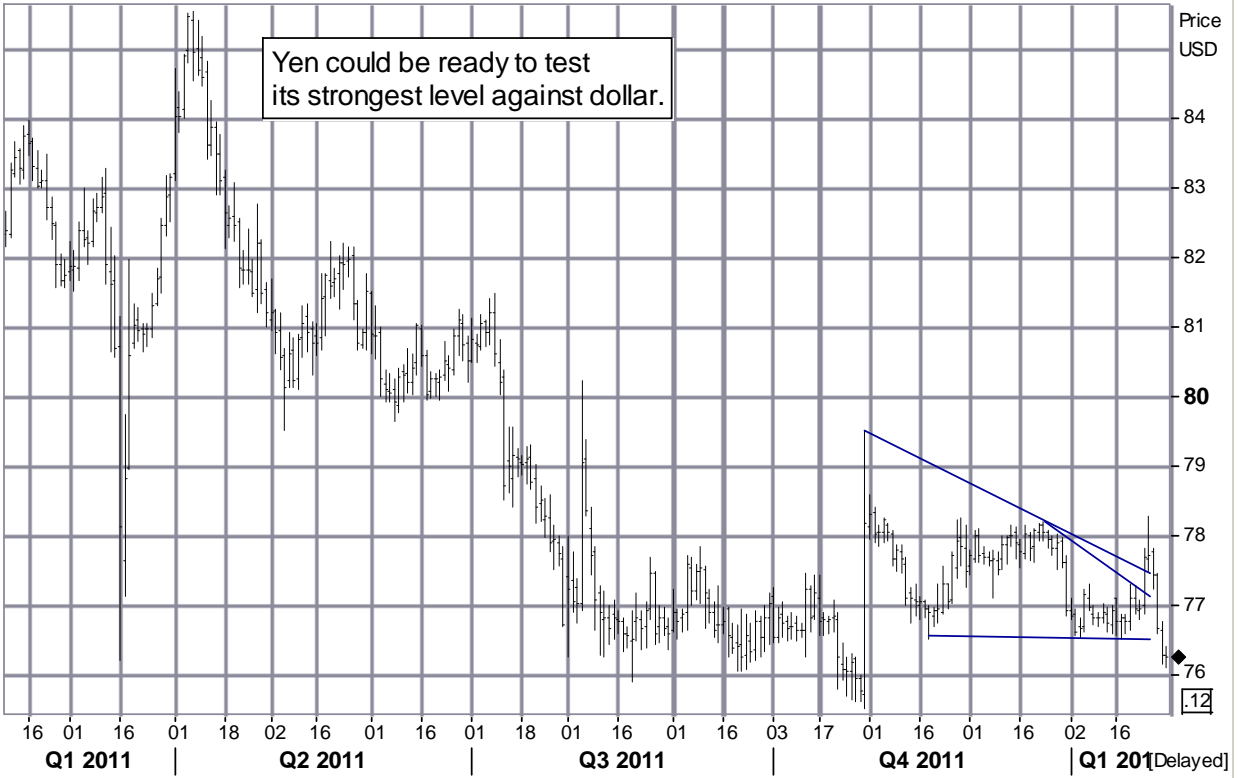
Dollar is stuck in channel lower post-Fed.



Daily Euro

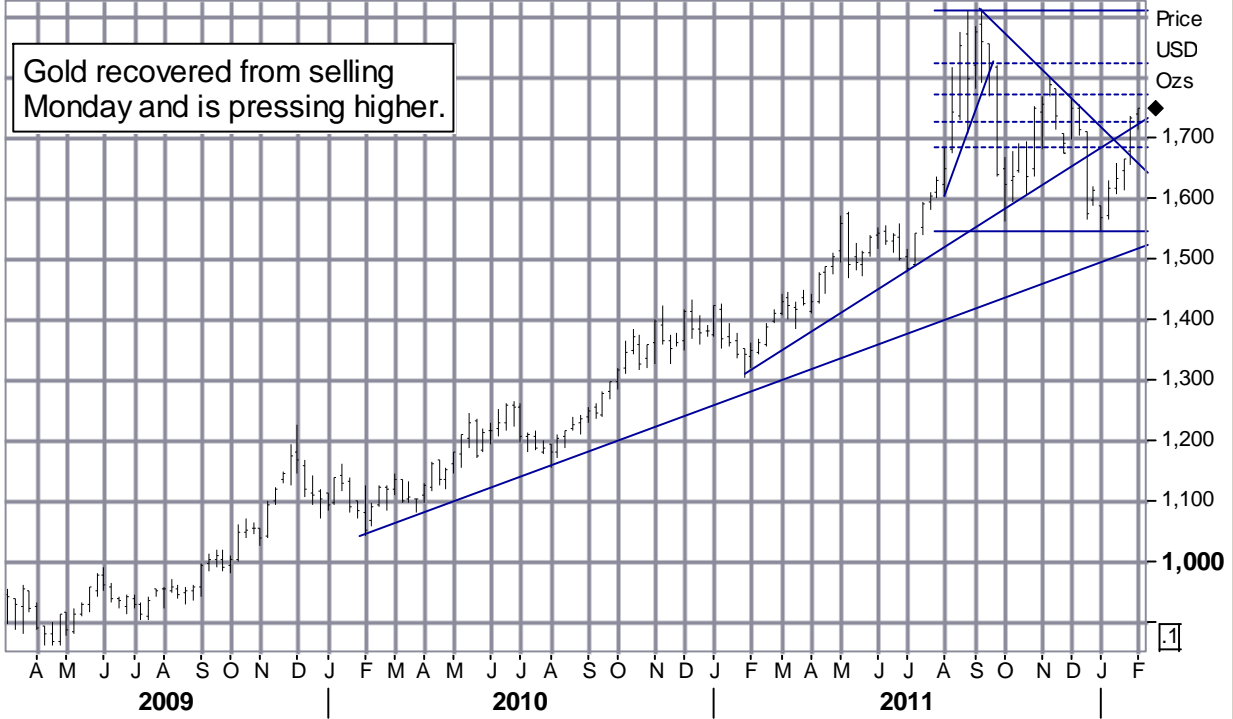


Daily Japanese Yen



Weekly Gold

Gold recovered from selling Monday and is pressing higher.



Daily CRB Index

CRB broke out of downtrend and takes aim at fall highs.

