The Fed’s Grand Experiment

By Michael J. Walker, CFP

The Federal Reserve has been conducting a grand experiment over the past five years. The Fed has attempted to stimulate the economy via their money printing efforts designated Quantitative Easing (QE) and zero interest rate policies (ZIRP). These programs have been active and ongoing and have been the driving force behind strong U.S. stock markets since the great recession of 2008-2009.

2013 was a strong year for U.S. stock markets, in fact the best year since 1997. As the year began, few analysts were looking for large gains in equities and fewer still were looking for a 30% plus romp in the S&P 500. Volatility in stocks remained low with the largest correction in the stock market less than 7% during the entire year.

While stocks rose strongly, earnings growth did not keep pace. S&P 500 earnings grew less than 5% year over year. Thus, most of the gains in stocks were the result of stock valuations increasing which means stocks are more expensive compared to one year ago. Higher stock markets usually go hand in hand with strong underlying economies but this time has been notably different in this regard. Measured by GDP, the economy continues to grow far below the ideas levels sought by the Fed.

As I write this missive, we are nearly a month into 2014 and stocks are trying to find their way. A poll of analysts currently finds that they are forecasting another year of 8-10% returns in the stock market. One thing that seems likely is that we are likely to see a year with higher volatility than last year’s relatively steady advance. A meaningful correction in the stock market is overdue and should not be a surprise if it occurs. This could help clear an overbought stock market and set the tone for a further advance. The Federal Reserve will likely continue to print money and they do not seem to have a problem if that money ends up supporting the stock market.

Yet there are large challenges for the economy and markets that an astute investor should keep in mind. The U.S. economy is not as strong as a 16,000 point Dow Jones Index would suggest. To me it’s more like an 8,000 - 10,000 point economy. Debt levels have continued to rise. It is widely understood that the trillions of dollars the FED is printing via QE and injecting in the system through bond purchases has pushed the stock market up to levels never seen before. A wise investor will remain alert to any change in trend and be ready to act accordingly.

In December the Fed announced that they will reduce or “taper” their purchases of bonds each month by $10 billion thus reducing purchases from $85 billion per month to $75 billion. The markets initial reaction to this news was positive but now the market is not so sure. The jury is still out on whether the Fed can continue to reduce future stimulus without upsetting the stock or bond markets and this will determine whether the Fed’s grand experiment is ultimately successful.

January is "new money" month with people beginning to contribute to retirement funds again. The so called "January effect" tends to see markets rise in January so that can be a positive effect on the markets, but so far the January effect has been minimal. Also, while the Fed has tapered, they are still supporting markets with $75 billion per month in bond purchases. That is a powerful force for the markets.

To sum it up, I believe we are overdue for a normal and healthy correction in the stock market. Whether a correction, should one occur, develops into a more serious decline or not, we will have to wait and see. Despite the Fed's significant support of markets, there remain large and very real problems that the market must deal with. Despite recent signs of increased growth in the economy, stock market valuations are high. Overall this recovery remains sluggish even five years removed from the great financial crisis and remains dependent on huge ongoing stimulus of QE and SIRP. There seems to be little interest in government to deal with these problems and our leaders seem unable or unwilling to find a way to control spending or pay down the enormous debt that continues to accrue.

Markets are going to have to deal with these problems eventually. If the Federal Reserve continues to provide QE as they have been doing, which seems likely, history suggests that it could lead to higher inflation, higher interest rates, and other problems that could be challenging for the economy and for stock prices. Yet the efforts of the Fed through their QE and low interest rate policies have been the driver of stocks. Owners of stocks should be prepared for a potentially volatile year ahead with surprises the norm, not the exception.

In 2013 U.S. interest rates rose despite the ongoing monthly purchases of bonds by government. Bond prices move inversely to interest rates meaning that rising rates cause falling bond prices. If the Fed continues to reduce the amount of QE it supplies to the markets, then higher interest rates could be coming. My personal belief is that it will be difficult for the Fed to reduce QE by a meaningful amount without negative effects in stock, bonds or currency markets. The Fed has indicated that they want to continue to reduce the amount of money they print, but the Fed will respond to the action in the markets. If markets turn volatile to the downside, the Fed may reverse course and respond with more QE, not less.

The ongoing debate of whether we are headed for inflation or deflation continues to rage on. If inflation is where we are headed, then owning short term bonds or no bonds at all may be the way to go. On the other hand, if deflation gets the upper hand then owning longer term, high quality bonds would be the preferred choice. Tax free municipal bonds appear to be a relative value to treasury bonds but both are subject to losses if interest rates continue to ratchet up.

I am in the inflation camp. The Fed has a printing press and has demonstrated they will use it, but there is no guarantee that the large levels of debt won't result in deflation. History suggests that money printing has nearly always caused higher levels of inflation and interest rates. It is my opinion that the Fed is involved in a grand financial experiment with an unknown outcome. Time will tell but with interest rates so low, it seems to me that the path of least resistance is up for interest rates and up for inflation. The inflation / deflation debate will continue until the outcome is known.

Gold and silver spent most 2013 in full correction mode making for a difficult year for precious metal investors. Snapping a twelve year string of rising gold prices since 2001,

gold finally experienced a down year. This correction has been painful for gold investors, but the correction was overdue, normal, and healthy for the gold bull which is in its 14th year. There are positive signs that the precious metals market correction may be nearing the end this correction and this could set up the resumption of the bull market sometime later this year.

Gold and silver prices have made some encouraging progress over the past few weeks and mining stocks have outperformed underlying metal prices. While no one knows for certain if gold and silver prices have bottomed or whether there is more downside yet to occur, the fundamental case for gold and silver remain strong and the ongoing QE and ZIRP policies of the Federal Reserve are nearly the ideal back drop for the eventual resumption of rising prices. Time will tell but I think gold, silver and select other commodities are one of the few areas of the market that appear to be undervalued at present. At some point I believe that investor sentiment will again swing back to favor precious metals and when it does the patient investor could be reward very well. A dollar crisis or an unexpected news event could be the catalyst that sends metal prices higher.

Wishing you and yours a very healthy and prosperous new year!

Michael Walker is a Senior Financial Advisor and Certified Financial Planner (CFP) with over 30 years in the industry. As President of Walker Financial Group in Scottsdale Arizona, he works with families and small business owners in all areas of investments and financial planning.

Michael J. Walker, CFP
Walker Financial Group
480-540-2728
1-800-306-9585
mjwalker@wfafinet.com