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Note

BURNEY COMPANY
INVESTMENT MANAGEMENT

The Fed's Next Move Will Have an Impact on the Stock Market

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Following its first policy meeting of 2013 concluded on January 30th, the Federal Reserve will continue to purchase $40 billion per month in mortgage-backed securities, $45 billion in longer-term US Treasury securities, and hold the fed funds rate at 0%-0.25% "at least as long as the unemployment rate remains above 6.5%".

This is essentially status quo to current monetary policy and hardly a surprise to anyone on the street. So why did this meeting catch so much attention? Last quarter preliminary GDP unexpectedly dropped 0.1%, the first time in more than three years, reflecting a still worrisome broad economy (though some attribute this drop to transitory factors such as Sandy). In the meantime, as predicted by our previous note Housing and the Recession, the housing market, consumer spending, and business fixed investment, sectors that are interest-sensitive, continue to improve – a positive sign that the Fed's policy is working. Now a major question lingering on people's minds is how long the Fed will continue its bond-purchase program.

We expect the Fed's bond-buying program and extremely low fed funds rate to continue at least to midyear 2013, but private sector interest rates could see a rise before that.

Fed officials said they saw continued downside risks to economic outlook. A 22% decrease in defense spending likely contributed to the fourth quarter's GDP contraction and more government spending cuts are set for March 1st. Income and payroll tax rates went up for most Americans this year and may soon have an impact on private spending and business activities. These uncertainties together should keep the Fed's stimulus program in place for a while. However, there are at least two factors that have the potential to cut the program short. The first is an economic factor. The monthly $85 billion bond purchase meant to hold down long-term interest rates to encourage spending, investment, and hiring could also cause inflation and new financial bubbles. If inflation doesn't stay below 2%, the Fed might have to abandon the program early.

The second, unfortunately, is a political factor. The Fed earned $91 billion last year on its bond portfolio, of which nearly $89 billion was sent to the Treasury as required by law. In January 2013, the Fed's staff economists found that several years down the road, when the economy is stabilized and the Fed is to sell bonds to raise short-term interest rates, it might have to sell at losses. At that time, estimated to start in 2017, it would have no revenue to hand the Treasury for four years. The consequences of this on congressional budgeters and American taxpayers may cause political headaches that could weigh on Fed officials' decision today of whether to discontinue the bond-buying programs sooner rather than later. Even though the Fed's direction is largely framed by Chairman Ben Bernanke, who is believed to be a supporter of a longer growth spur, one voting member already dissented in the most recent meeting.

We expect the bond-buying program and extremely low fed funds rate to continue at least to midyear 2013, but private sector interest rates could see a rise before that. Later this month, Ben Bernanke will deliver his semiannual testimony to Congress, in which he might leave clues as to how long the Fed expects to carry on its program. Under low interest rates investors seeking higher returns overheat riskier and speculative assets. But the Fed's program cannot go forever. When it eventually withdraws, sectors that are interest-sensitive would take a hit immediately.