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Fed Holds Steady

The Federal Reserve Open Market Committee held their regular two day meeting last week and decided to hold steady on interest rates again. The battle with inflation is the primary reason they have left rates unchanged for the last eight meetings. Chairman Bernanke watches inflation and has a target rate of between one and two percent for inflation after taking out certain items like energy costs from the calculation. The current rate is just at 2%, the upper range of his target.

Economic growth has also been very slow. The housing market and the worry about sub-prime mortgages are a definite drag on the general economy. The Fed has repeatedly stated that they do not expect the housing market to have a substantial long-term adverse effect on the overall economy. It is a large piece of the economic puzzle but, in this situation the Fed does not expect it to cause major problems.

We shall see. This debate has plenty of powerful people on both sides. Nowhere is the discussion more interesting than at Pimco where Bill Gross, one of the best bond managers (and hence-watcher of interest rates) in the world has recently hired Alan Greenspann, former chairman of the Federal Reserve. It appears that the two of them disagree completely on the effect the current housing situation will have on interest rates. One is convinced that rates have to come down and the other is saying that the Fed may have to raise rates.

I am definitely in the wait and see camp. I certainly don't know what is going to happen so I am approaching my bond investments very conservatively. New money targeted for bond investments or bond investments that have matured are being held in a high yielding Money Market account at Schwab where it will earn about 5% without any time commitment or principal risk. Here is why: Bond prices move inversely with interest rates. If rates go up, the value of bond holdings will decrease. If rates go down, the value of bond holdings will increase. The thing is, if rates go up you get to buy new bonds with higher yields and if they go down you can always increase the length of time to get a slightly better rate. Since we don't know where rates are headed it seems more prudent to hold the money in a safe, high yielding place until the direction is clear.

The stock market has once again entered a defensive phase. Throughout the last month new highs have been reached on many occasions while the number of companies contributing to the records has been declining. The tide has finally reversed as it did back in the beginning of March. There was no big event to spark it other than the interest rate debate. There was just a slowdown and reversal of the buying trend that has been happening for the last two months. This could be another short-term trend for the stock market or the start of something larger, we will just have to watch and see how it plays out this time.