

November 11, 2009

What keeps us up at night

What would put an end to this bull market?

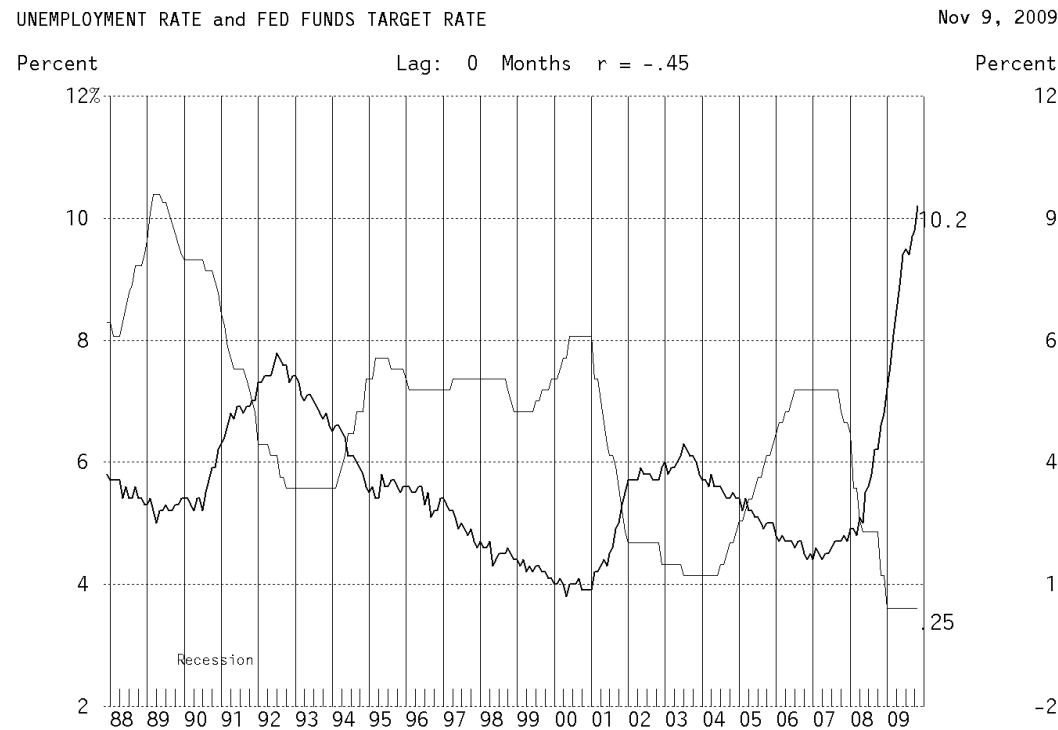
The unemployment rate hit 10% last week and the stock market rallied. How can this be?

Is it just that most traders are a bunch of heartless creeps? There's something to that, but actually the market is more worried about the Fed Funds Rate than the unemployment rate. And so are we.

With positive growth in GDP beginning this last summer and profits up among employers, jobs will be created in 2010. The market also knows that unemployment keeps rising even after recessions end and definitely long after the stock market bottoms.

The worry among investors, and at this desk, concerns the timing of Fed tightening--- when will the Fed begin raising interest rates? That's when the current bull market will end or moderate forcing us to a more conservative stance in our portfolios. Luckily we have an early warning system in place for this event.

The unemployment rate will provide us a clue as to when the Fed will act. The following chart shows the last two cycles, when unemployment peaked followed then by increases in the Fed Funds rate many months later. Unemployment peaked in mid 1992, but the Fed didn't raise rates until early 1994. The same thing happened between mid 2003 and mid 2004.



Going back to WWII the Fed has never raised interest rates until the unemployment rate has fallen.

So what are we worried about? It's all this talk about inflation, currently showing up in commodity prices and projected in the future for lots of reasons. We are concerned that the Fed will be spooked by all this inflation speculation and raise rates too early. That could tip us back into recession and severely damage stock prices.

Bernanke seems to understand the problem (and the history), but many at the Fed do not.

We agree with those expecting the Fed to act toward the end of 2010. That gives us a lot of time to continue the repair process in our portfolios. But if the Fed makes a mistake early in 2010, we will act to protect the profits we've made since last winter.

Best regards,



Daniel A. Ogden