A Tale of Two Realities

The world has gone crazy. You need to stay sane.

If you watch the news, or read through a list of current economic statistics, things look pretty dismal. Growth is weak. Income is flat. Consumer spending has slowed. European countries are struggling with high unemployment. Youth unemployment is over 40% in four of those countries – Greece, Italy, Portugal, and Spain – and is high in the U.S. as well, currently 16.1%.

Meanwhile, governments are running large deficits and central banks are printing mountains of cash. College-bound kids are piling on mounds of debt and struggling to find jobs after graduation.

But if you look at the equity markets, things appear bright and sunny. We're near record highs. Companies are awash in profits. Interest rates are exceptionally low.

How is it possible that these two worlds – economics vs. financial markets – can peacefully coexist? The short answer is, they can't. The more involved answer is, they can't peacefully coexist for long.

Right now the economy is suffering from a lack of demand. We know this and have warned about it often. That lack of demand is a normal part of our economic cycle that occurs when the largest group in the economy (the Boomers) enter the phase of life where saving is more important than spending. This lack of demand is compounded by a dramatic reduction in the people (beyond college students) who want to take on credit. These two trends result in a slack economy, shown through high unemployment and stubbornly low wages. This makes perfect sense; but it's also where things get tricky.

The government and the Federal Reserve recognize this lack of demand, but they aren't sure how to fix it. The Fed only has a few tools – like interest rates and money printing – so it does what it can. The Fed is busy keeping interest rates low and printing money. This is a fabulous recipe for pushing stocks to the moon because it makes other investments, like bonds, less attractive. The problem is that the efforts are not actually fixing our economy. We are muddling through and, at this point, we're somewhat resigned to a low growth level.

But the Fed keeps printing, so the market keeps rising. This is short-sighted, but it's where we are. The problem comes in when the Federal Reserve considers slowing its efforts. This hasn't happened – yet – but the members of the Fed Open Market Committee (FOMC) discussed at their last meeting, which ended May 1, how and when this might occur. When the minutes were made public, the market swooned.

Now, keep in mind that nothing economic had changed. We were, and are, in the same place as we were before the Fed minutes were published last month. The only thing that has changed is that market participants are acknowledging the Fed might actually quit printing $85 billion a month.

So here we are, with stubbornly sluggish economic numbers that have brought on a massive response by our central bank, and equity markets that are reacting to the central bank, not the economic numbers.

It makes no sense, but it's where we live. So our job is to recognize the craziness in the system. The markets are not reflecting a healthy economy, but instead are reacting to the size of the Fed's intervention programs. We'll watch these programs closely, because they hold a key as to when the markets could take a break from their long march higher.

Sincerely,

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