

# The Fed's Not-So-Hidden Agenda

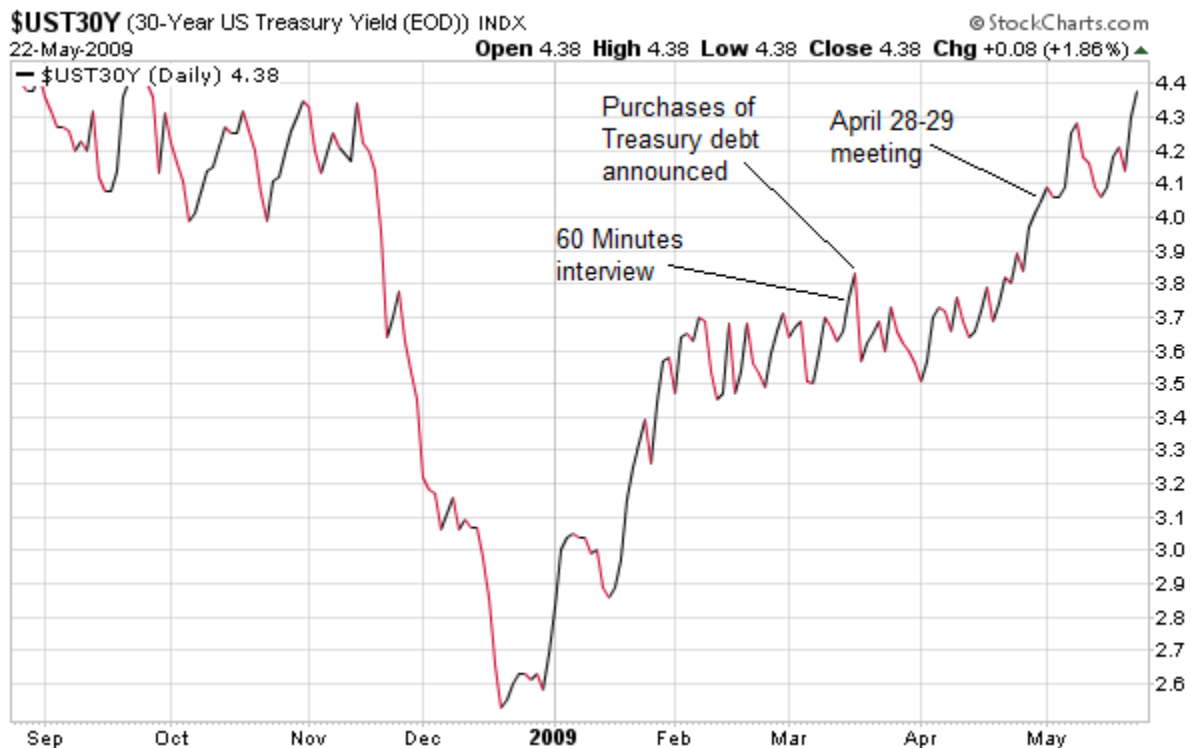
May 26, 2009

“When someone becomes a Fed governor, they take them into a back room and perform a DNA transplant on them. They come out of that room viscerally, almost genetically, focused on preventing deflation from happening on their watch.” – John Mauldin, *Thoughts from the Frontline*

The Federal Reserve revealed last week that it now expects economic activity through 2011 to be weaker than it had forecast in January. According to minutes from the April 28-29 FOMC meeting released Wednesday, the Fed pointed to a deteriorating job market as the primary culprit. A more likely explanation is that the Fed is becoming concerned about upward pressures on long-term interest rates.

If deflation is the Fed's principal adversary, then a lethal cocktail of deflation and high interest rates is its worst nightmare. Deflation increases the real value of nominal debt and lowers the value of underlying assets, while high interest rates make debt more costly to finance. In today's debt-soaked environment such a combination would be devastating, especially for the housing market and, by extension, the banks. Not to mention the federal government's own burgeoning debt swelled by recent bailouts and stimulus programs.

The chart below shows the 30-year yield for U.S. Treasury bonds.



Charts courtesy of [StockCharts.com](http://StockCharts.com)

Prior to Bernanke's "green shoots" interview with *60 Minutes*, yields had recovered from extreme volatility and settled into a narrow range around 3.6%. But rumors of the Fed chairman's upbeat comments began to rattle the Treasury market even before the March 15<sup>th</sup> broadcast. The following Wednesday the Fed announced it would begin large-scale purchases of Treasury bonds in an effort to contain long-term rates. However, as yields climbed above 4% in late April it became clear that Fed buying would not be enough to make a significant difference. The plan to engineer low long-term rates through quantitative easing has been derailed at least for now – in part by the Fed's own green-shoots rhetoric. Apparently the Fed did not consider that the *60 Minutes* viewing audience might include a few bond traders.

In contrast, the weaker economic forecast released by the Fed last week appears to have been formulated primarily for bond-market consumption. Even so, this new forecast is only slightly less absurd than January's. For the Fed to succeed at this game they need to bifurcate their message: convince the bond market that the U.S. economy will remain very weak for the foreseeable future, while simultaneously convincing the general public that all is well and recovery is underway. Alternatively, the Fed could just go back to being a central bank instead of a propaganda machine.

### **Standard & Poor's Downgrades U.K. Outlook**

Further complicating matters for the Fed was S&P's warning Thursday that Britain may lose its AAA credit rating because of soaring government debt. Though the revision from "stable" to "negative" outlook does not apply to the United States, the report nevertheless led analysts to question how long the U.S. government can continue trying to stimulate the economy through massive deficit spending. In that respect the Fed's new economic forecast appears to have backfired, as continued economic weakness would batter public finances through higher expenditures and lower tax receipts. Treasury yields surged again last week and rightfully so. Until the Fed can reestablish some level of credibility, its sanguine inflation forecasts remain just as untrustworthy as those for economic growth.

### **The Picture**

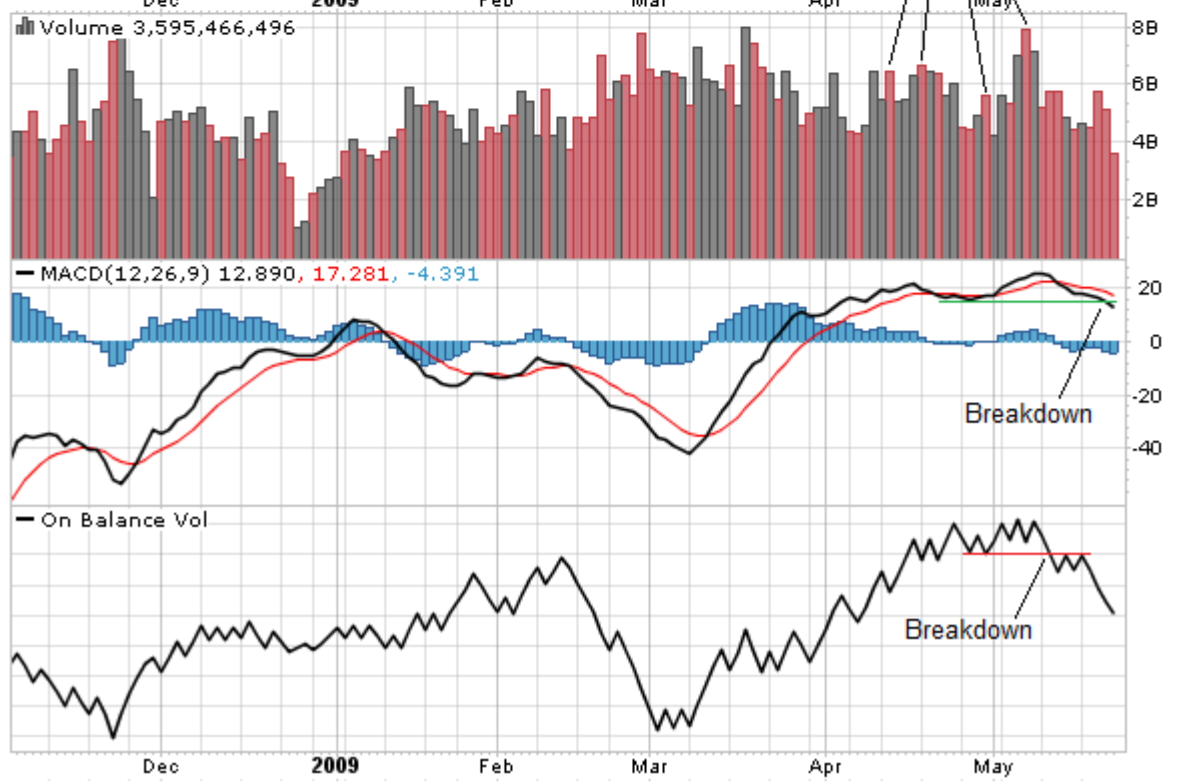
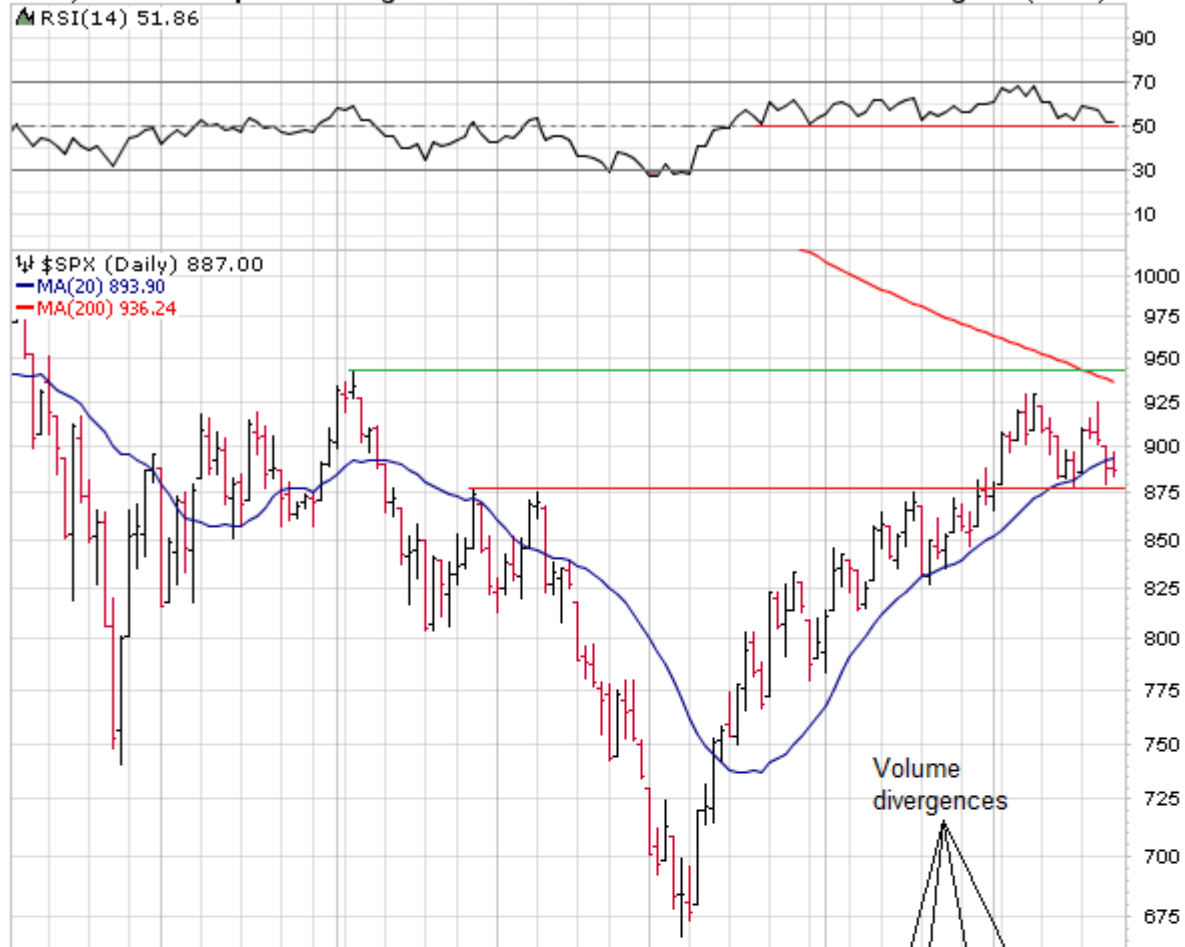
The stock market held up well last week despite the negative news flow. The S&P 500 index remains above key support near 875, though it has broken below its 20-day simple moving average. One of the most interesting features of the chart below is the series of volume divergences that developed as the rally off the March lows began losing momentum in April. These divergences show up in the volume histogram as higher red bars sandwiched between shorter black ones. They indicate distribution is occurring as well-informed investors use market strength to exit long positions and establish shorts without significantly affecting prices. The recent breakdown in Granville's On Balance Volume indicator confirms the negative price-volume relationship, as can be seen in the bottom panel of the chart.

Momentum has turned somewhat mixed, with MACD breaking down last week after having generated a bearish cross the week before. RSI, however, remains above the important level of 50. We'll have to see what this week brings.

**\$SPX (S&P 500 Large Cap Index) INDX**

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22-May-2009 **Open 888.68 High 896.65 Low 883.75 Close 887.00 Volume 3.6B Chg -1.33 (-0.15%)**



A major challenge for the market going forward will be overhead resistance. Short-term resistance at 894, 925 and 930 could be fairly weak. However, the 200-day moving average currently at 936 will be a much stronger barrier, as will the 944 level. If the May 7<sup>th</sup> volume divergence exhausted the March rally, as may well be the case, then these resistance levels may prove difficult to overcome. One likely outcome under that scenario would be additional distribution over the next several weeks as the market moves sideways with gradually diminishing upside testing. Though further gains from here are possible, we continue to believe that a secular bear market in stocks remains in force.

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