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OBSERVATIONS ON THE MARKET

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We are once again reminded that forecasting is a very tricky business. If you remove the largest buyer from a crowd, you can only assume that prices are going to go down. On January 2, 2014, 10-year treasury bonds had a yield of 3.03%. In October 2013, 10-year rates were at 2.47%, and they began moving up anticipating that the Fed was going to start reducing their purchases of bonds. The Fed did start to reduce their monthly purchases from $85 billion per month to the current rate of buying $25 billion per month. They will probably completely stop buying bonds before the end of the year. Even if you foretold the Fed's action perfectly and guessed that the Fed would be out of the bond buying business by the end of the year, interest rates didn't cooperate, they didn't go up, interest rates have declined to 2.40%. So much for predicting the future.

This is not the only part of the investing world that is hard to reconcile. Bonds of less credit worthy countries are at lower yields than the good old USA. Spanish 10-year debt is currently at 2.37%, France is only paying 1.38%. Italy, who was supposed to be broke by now, only pays 2.58%, a fraction more than the US. Ten- year German bonds, the strongest economy in Europe and also one of the best in regards to credit ratings, are at .99%. Interest rates have been fooling a lot of people for several years now. So now what does that mean for the stock market?

Will higher interest rates kill the stock market? History suggests they do not, at least for a while. The logic is simple. The beginning of a higher interest rate cycle is usually the result of a stronger economy. The effects of stronger corporate earnings offset or contribute more to stock prices than the negative of higher interest rates. Because rates are currently so low, it will take them a while to reach a point where they would arguably slow down the economy or be a drag on stock values. The forward interest rate market (which is determined by what the different maturity of interest rates are now) puts the one-year treasury rate at .87% one-year from now. Based on current rates, one-year treasuries will pay 1.88% two -years from now. They are currently at .107%. Another way to look at this is; if one-year CD's pay 1.88% in 2016, it doesn't change the game much. What will change the game?

Besides the usual suspects of a weakening economy or a terrorist attack in the US, higher inflation is one of the larger risks. With Europe slow, China in a slump, and commodity prices mostly stable, broad inflationary pressures don't appear to be a risk yet. Then consider that the velocity of money continues to fall and now we have another crystal ball mystery. With low interest rates and lots of easy money, one would assume that money would have started to circulate through the economy faster than it is. The velocity of money is at a 55 year low. It would appear that before we get any worrisome inflation, we need money circulating through the economy at a faster pace than it is, not 40% slower than it was in the 1990's.

If you think you know what the stock market is going to do in the next six-months, remember that the Euro didn't act like it was supposed to during the European debt crisis, it held its value. The stock market also recovered from the 2008 - 2009 recession much faster than anybody predicted back in 2009. Now, interest rates don't seem to be doing what they are 'supposed' to be doing. Maybe, we are in the sweet spot of low inflation, just enough growth to fuel higher corporate profits, and the appearance that the economy is getting a little better. However, being just a little cautious may not be a bad thing either, because who knows what will happen in the next 12 months.