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MCAG MACRO: To Everything, Turn

September 15, 2010

In what is historically the worst month for stocks, equity indexes are putting on a good show. So far for the month of September, the Dow is up 5% and the S&P, 6%. But there's some noise beneath the surface. Of the many factors at work here, technical and fundamental, two could inflict the most influence, or at least put us on shaky ground: Fed action and mid-term elections. Yesterday's price action means markets are starting to realize this, having been positive for most of the session and then ending up right back where they started. Uncertainty is back.

In the period between the last Fed meeting on August 10th, until Bernanke's Jackson Hole speech on August 27th, stocks fell by 6.5%. This was a direct result of digestion of the announcement to reinvest maturing mortgage-backed securities to mean that the economy was in worse shape than we thought and needed more help. It was an invitation to speculate on how much more and what kind of further quantitative easing might come from the Fed. Admittedly, the move sent the wrong message, which Fed members had feared might happen. The Jackson Hole speech did damage control as did the release of minutes from the meeting and since then stocks have rallied by over 5% and bond yields have stabilized somewhat. Based on that, and further positive economic releases, I didn't think further QE was on the table, at least not unless "the outlook were to deteriorate significantly," but there have been several analyst calls for renewed proactive QE and lower rates. A Bloomberg article released Monday has Goldman and Pimco forecasting that the Fed will resume easing by the end of the year. Some think the possibility is already baked in, in Eisenhower era low yields. I strongly disagree that this is a possibility and I heard someone call this the "nuclear option." It will not help the job market, nor will it help the housing market, the thorns in the side of recovery. What it will do is inject fear into the markets and diminish Fed effectiveness, as illustrated by the result of the last meeting. That being said, the options on the table if they were to take further action are worth noting because of each one's effect on the markets. They are purchasing additional longer-term securities, altering the Committee language in regard to the extended period, and lowering the interest paid on excess reserves. The meeting is on September 21st. More to come leading up to the meeting.

My other favorite market churning is mid-term election. All over the news today is the number of upsets within party lines. People want change on the local level and on the federal level that will be reflected exponentially. The push is towards more business-friendly and market-friendly policies including the extension of tax-cuts and increased incentives for business spending. As a result we saw more winners come out of so-called “extremist” ideals. I will go deeper into this issue and its effect on the markets in days to come. However, allow me to point out another good point made by James Mackintosh. “Since 1946, equity returns during gridlock have been lower than when the president’s party controls Congress. During gridlock, the S&P 500 has averaged 14.8 per cent in the two years after the new Congress or president takes office, against 19.9 per cent without gridlock. Conversely, bonds have produced much better returns...” However... “The average return when a Democratic president faced gridlock was almost 17 per cent, against less than half that when a Republican faced gridlock. Stopping Dems pushing for big government seems to be good for markets. In fact, though, what matters is not gridlock but whether elections are presidential or midterms. Average returns in the final two years of a president’s term are far higher, at 17.1 per cent, than the 4.8 per cent in the first two. Adjust for this, and there is only a small gap between the parties.”

I dare say if recent election results foreshadow the regime change markets hope for, we aren’t going to need any further quantitative easing. Precocious in this judgment I may be, it’s history that I am basing this on. Timing is everything.

Please respond with your thoughts and questions and stay tuned.

Should markets hope for US gridlock?

By James Mackintosh - Published: September 10 2010 01:51 | Last updated: September 10 2010 01:51

<http://www.ft.com/cms/s/0/07cef4f0-bc6a-11df-a42b-00144feab49a.html>

Yields Fall to Eisenhower Low in Pimco View of the Fed

By Liz Capo McCormick - Sep 13, 2010 1:41 PM ET

<http://www.bloomberg.com/news/2010-09-12/treasury-yields-decline-to-eisenhower-low-in-pimco-bofa-view-of-fed-easing.html>

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