



POTOMAC
STRATEGIC INVESTMENT

CAPITOL MARKET REVIEW

In This Issue: The Federal Open Market Committee Speaks, Everyone Listens, Even if they Don't Like What They Hear

At the Close: SPX 1237 US10Y 1.98% Gold \$1736 Oil \$92.43 Nov. 2, 2011

For at least one day, The Federal Reserve's Open Market Committee announcement and press conference controlled the ebb and flow of investment markets. While markets were higher due to stability in the Eurozone credit crisis, The Fed's statements were cautious at best.

Fed watchers and the larger investment community had not expected any changes in policy. In many ways, the Federal Reserve has already mapped-out years worth of meetings news. Interest rates will remain near zero. The Federal Reserve will continue its ongoing programs to purchase mortgage securities of longer duration as its shorter maturities in Treasury securities expire. Monetary policy will remain "accommodative."

However, for the third time in three announcement cycles, the Federal Reserve lowered GDP projections and increased unemployment expectations. Here are sobering numbers. According to the Fed, 2011 US GDP will not exceed 1.7%; this down from a projection of 2.7%. For 2012, the Fed now expects US GDP will be no more than 2.9%; earlier predictions were for 3.7% growth.

Unemployment rates were also ratcheted higher. The 2011 unemployment rate will remain above 9%. The 2012 unemployment forecast was raised from a range of 7.8% - 8.2% to 8.5% - 8.7%. While CMR does not put much faith in *any* economic forecasting further than two years out, the Fed also sees 2013 unemployment between 7.8% - 8.2%.

These are bad economic numbers for President Obama as well as Congressional incumbents be they Republican or Democrat. Economic numbers like these may even prove difficult for Tea Party Members and Senators to defend.

Without getting into parsing every word and phrase of the report, and Bernanke's press conference, a few major themes did emerge and should remain as key catalysts. Bernanke and the Fed are clearly frustrated that the pace of economic growth remains below trend; same with a stubbornly high unemployment rate.

Bernanke is taking credit for what he sees as stable inflation, even though he conceded that energy prices, and to a lesser extent food prices, had been volatile and had been a drag.

However, Bernanke is resolute in his opinion that the historically high unemployment rate is "cyclical," NOT "structural." This is a very important economic point that should

be considered carefully in a fiscal policy context. CMR is aware that other economists are not as sure. And that a growing number maintain that many long-term unemployed workers are trapped in markets where they cannot move to take even lower paying jobs. While Bernanke did allude to this phenomenon, he was not willing to say it was something that required a policy initiative.

Bernanke did make it clear that part of the lag in the economy was a function of housing, tight-credit, (particularly for small business,) and the need for further de-leveraging of household balance sheets. As long as the Fed maintains that the high unemployment rate is cyclical, no further monetary policy will be considered.

That said, it's also clear that Bernanke is taking credit for an element of his mandate not often discussed. Bernanke claimed that Fed action had prevented “deflation” in the American economy. And again reminded the audience that monetary and fiscal policymakers have few tools to deal with deflation. CMR sees Bernanke's reference to deflation as being important for what Wall Street bulls want; another round of “quantitative easing.” If Bernanke sees deflation on the horizon, the Fed policy statement today and Bernanke's comments in the press conference indicate that he will quickly act to pump more liquidity into the system. Quantitative easing remains the key monetary policy tool Bernanke will not hesitate to use if he feels the economy is weakened by either a hard landing in China, or a more serious crisis in Europe.

As CMR has said for months, the risk to both the US economy and global emerging economies remains in Europe. This is the short-term concern of the Fed. In response to several questions on the topic, Bernanke indicated that while the Fed is in extensive talks with central bankers throughout the globe, with respect to Eurozone issues, that may not be enough. Paraphrasing...*The Fed can talk but that does not mean Eurozone bankers will listen.*