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COMMENTARY

Market Opinions And Topics Of Interest
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The Bear Market Part 3 -- Maybe Fed Policy Is Affecting Stocks After All

In Part 1, we showed how the bear market has been concentrated in the technology sector. In part 2, we showed how many might be over-stating the "reverse wealth effect" on the U.S. economy. In this part, we look at how Fed policy has been affecting the stock market.

Many market commentators have noted that Fed policy has not been correlated with the stock market in recent years. Therefore, Fed policy does not work anymore with respect to the old stock market adage "don't fight the Fed." Is this true?

Non-Tech Stocks and The Fed

When viewing Chart 1 within the context of Fed policy, the S&P 500 ex-technology appears to be reacting to Fed policy, as we would expect. Our proxy for Fed policy is the "fourth deferred" Fed Fund futures contract. When this contract is pricing in any amount of tightening, we grade this as "Tight Fed Policy" and when this contract is pricing in any easing, we grade it "Easy Fed Policy."

The S&P 500 ex-technology worse when the Fed is tightening and better when the Fed is easing. The one exception was May 1996 to January 1998 when these stocks did well despite the fourth deferred fed funds contract suggesting a tight Fed policy. During this period, the Fed raised rates only once in 2 ½ years – a 25 basis point hike on, March 25, 1997. The market did not have a "lot of Fed to fight" during this tightening period, and this may explain why it was able to shrug off Fed policy and rally nicely.

In the current period, non-technology stocks have struggled, but the fed funds futures market is suggesting the easing cycle is far from over.

Tech Stocks and The Fed

Of course, investors want the Fed to use Fed Policy to levitate technology stocks (NASDAQ). The problem is that Fed policy has never shown a

tendency to correlate with the returns of technology stocks.

Chart 2 shows the S&P Technology Index and Fed policy (the same measure used in Chart 1). Fed Policy and technology stocks do not show the same correlation to Fed Policy that the S&P ex-technology Index does.

Conclusion: "Don't Fight The Fed" Still Works

Historically, an easy Fed policy has been bullish for the stock market. This is especially the case for non-tech stocks and may help explain why these stocks are "holding together" reasonably well.

Furthermore, consider that Wednesday's close saw financial stocks surpass technology stocks as the largest weighting in the S&P 500 (17.9% to 17.4% respectively). This was the first time since December 1998 that technology stocks were **not** the largest sector of the S&P 500 (they peaked at 35% in March 2000). Thursday's surge in the market (S&P 500 up 4.4%, S&P Financial up 3.7%, S&P Technology up 10.2%) again pushed technology stocks **slightly** ahead of financial stocks in the S&P 500 – 17.7% to 17.6% respectively.

Nevertheless, the influence of technology stocks on the S&P 500 is now equal to financial stocks.

Financial stocks, historically, have been highly correlated to Fed policy. Technology stocks, historically, have shown **no** correlation to Fed policy. This suggests that Fed policy could exert a greater influence on stock prices than even a few months ago.

An easy Fed policy is working in the favor of the S&P 500 ex-technology sector. This should prevent them from going into a bear market, which is good news for the economy and potentially troubling news for long Treasuries.

Chart 1

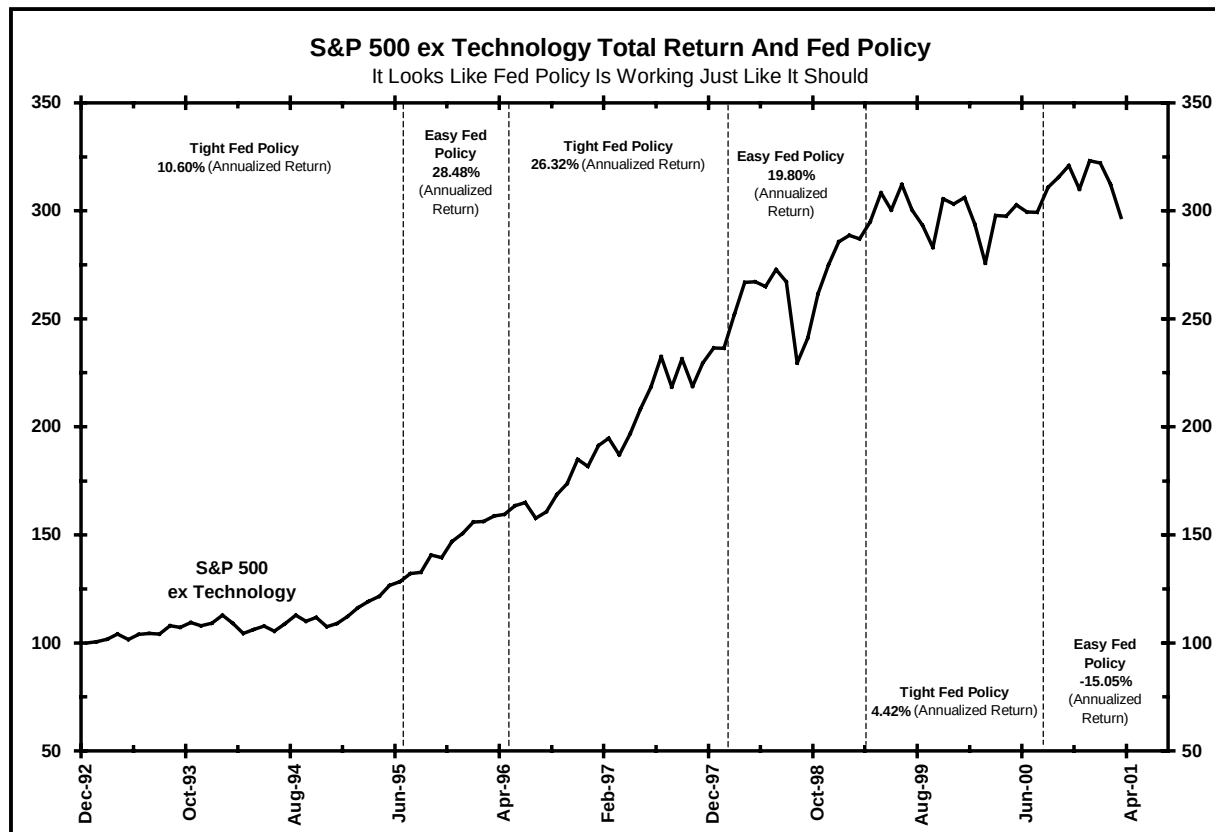
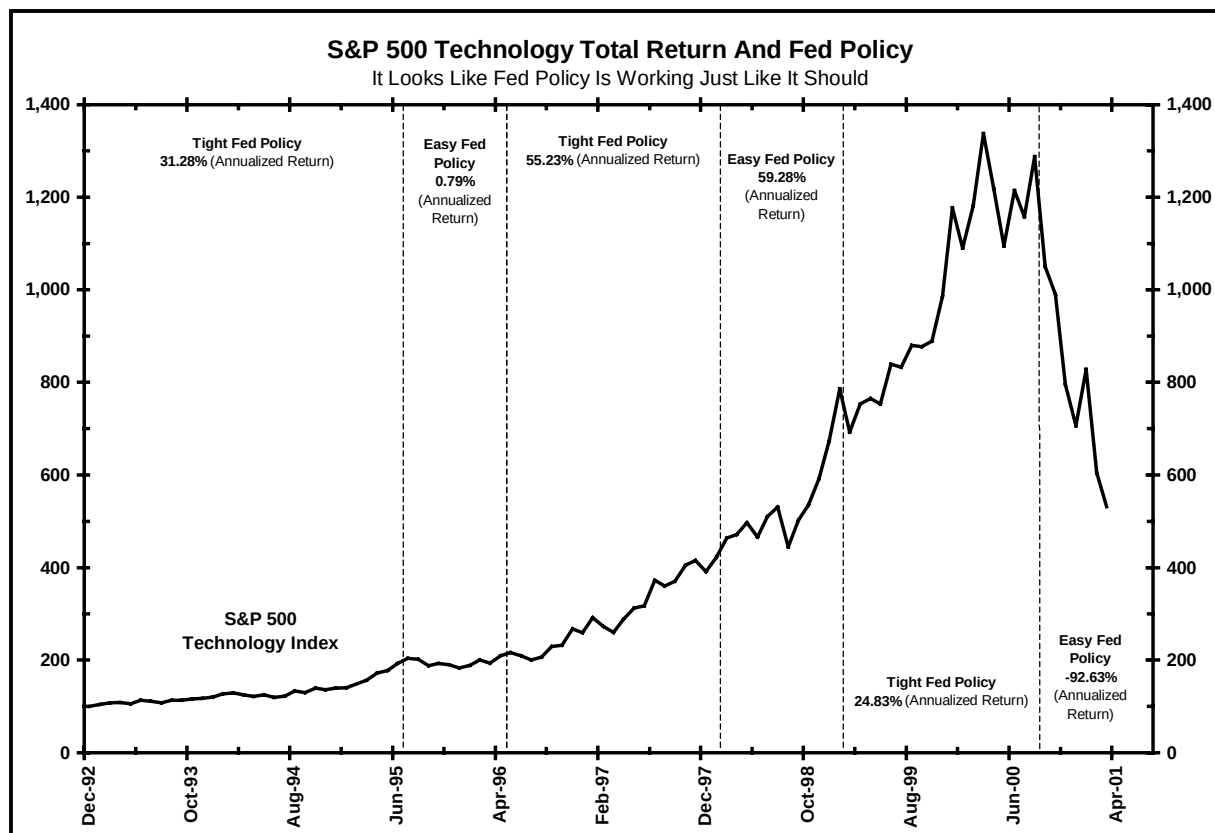


Chart 2



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