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Why Has Good Economic News Hurt Financial Markets?

The housing market is stronger than it's been in years. The U.S. economy grew an estimated 1.8% during the first quarter of 2013--not rip-roaring expansion, but an improvement over the previous quarter's 0.4%. Employment isn't where it needs to be, but companies are no longer shedding jobs in record numbers and the Federal Reserve thinks the unemployment rate will fall roughly another half-percent by the end of the year. Weeks and even months have gone by without headlines about a new European debt crisis.

And yet financial assets have been volatile recently. The benchmark 10-year Treasury yield has reached a level not seen since August 2011,* and since rising bond yields are typically accompanied by falling prices, bond markets have been hit across the board lately. The tidal wave of money that has gone into bond mutual funds over the last couple of years has slowed since yields began to rise, and has even begun to flow back out.** The S&P 500 has retreated recently from its string of record highs set in May. Prices for gold and oil also have seen weakness.

Paradoxically, relatively good news has made investors more anxious. Why has improving economic data somehow helped create turmoil in financial markets? The answer has to do in large part with the Federal Reserve and its monetary policy.

Good news, bad news

On June 19, the Federal Open Market Committee (FOMC) said that encouraging economic reports suggest that risks to the current moderate economic expansion have gone down. Assuming recovery continues, the Fed plans to begin reducing the economic support it has provided over the last couple of years. By the end of the year, the Fed could start reversing policies that have injected money into the economy through so-called "quantitative easing." It will first cut back on the $85 billion a month it has been spending to buy Treasury and mortgage-related bonds. Once the unemployment rate falls to around 6.5%, it will consider raising its target Fed funds interest rate above 0.25% for the first time in more than 4 years.

Low interest rates have helped make it easier for businesses to buy equipment and for consumers to purchase a home or make credit card payments. When the Fed began buying mortgage-related securities in November 2008, those purchases increased demand for bonds generally, providing support for bond prices and keeping interest rates low (since bond prices move in the opposite direction from their yields). Fed bond purchases also have given banks money to lend for home mortgages and business expansion. Those "easy money" policies were intended to help stimulate hiring, the housing market, and economic growth.

Taking away the punch bowl

Former Federal Reserve Chairman William McChesney Martin is often credited with saying that the Federal Reserve's job is to take away the punch bowl just as the party is getting good. The better the news about the economy, the more investors began to worry that a stronger economy would spell the end of easy money. Even before the Fed announced its blueprint for easing out of quantitative easing, markets were beginning to anticipate the potential implications for various financial assets.

Equities: Recent volatility has been sparked by worries that if the economy slows with less Fed support, corporate earnings could suffer. Also, dividend-paying stocks have been attractive to income-oriented investors seeking alternatives to rock-bottom interest rates; the Fed's statement raised questions about whether that would still be true if and when bond yields rise high enough to be competitive with dividend

yields. Foreign equities also have been hurt by concerns that if tighter U.S. monetary policy reduced American demand for their products, it could accelerate a global slowdown, especially in emerging markets whose economies depend on high prices for commodities such as metal ore.

Bonds: The Fed's statement prompted fears that if its bond-buying helped bond prices, the reverse could also prove true. If the Fed buys less, or actually begins selling bonds it has already bought, that could lower overall demand for bonds or increase the supply of bonds on the market. And as any consumer knows, lower demand for something or too much supply can lower its market value. Bond prices also have been under pressure as investors worried that higher interest rates eventually might cut the value of bonds that pay today's low interest rates.

U.S. dollar: The dollar has already gotten stronger, partly because of anticipation of eventual higher interest rates. A stronger dollar could hurt U.S. exports, which would become more expensive for customers who use a weaker currency. That could affect U.S. companies that derive a large portion of their profits overseas.

Commodities/metals: Concerns about the potential for a global slowdown as a result of the factors listed above have brought oil prices down in recent weeks. A stronger dollar, which is often accompanied by weaker global oil demand, tends to hamper oil prices. Gold, already in a slide since last October, also has suffered from a stronger dollar.

The Fed isn't the only factor contributing to recent volatility, and it hasn't been the only central bank to use quantitative easing to try to stimulate growth. Investors worry that whenever the United States does raise interest rates, other central banks might be forced to follow to make sure investors don't take their cash elsewhere. Any monetary tightening overseas could prove problematic. Europe has been mired in a recession for months and continues to have debt issues, while China's economic growth has shown signs of stalling and its financial system has been under pressure lately. Fears of the global impact of monetary policies are part of the reason equities also reacted poorly to the Bank of Japan's recent refusal to inject additional economic stimulus.

So what does all this mean for my portfolio?

Markets already on edge for weeks about what the Fed might do reacted strongly to its blueprint for an exit from quantitative easing. However, it's worth remembering that one of the reasons for any monetary tightening is that the Fed's outlook for the economy is more encouraging. The Fed also has left itself plenty of room to maintain its support if economic conditions don't continue to improve in the coming months; in 2010, it halted bond purchases because the economy was growing, only to renew them a couple of months later. Fed Chairman Ben Bernanke has said that when the Fed does begin to reverse course, it will be more like a driver easing off the gas pedal rather than slamming on the brakes.

If you hold individual bonds, remember that even if a bond's market value declines, the principal will be repaid in full if you hold it to maturity (as long as the issuer doesn't default). The closer a bond is to its maturity date, the closer its market value is likely to be to the amount of the principal; pay close attention to both a bond's maturity date and to the price you pay for it. Also, higher yields could provide some relief to those whose incomes from their hard-earned savings have suffered from rock-bottom interest rates.

Market risk based on monetary policy tends to have a broad-based impact, which can make it more challenging to try to protect your portfolio through diversification. And diversification alone can't guarantee a profit or protect against potential loss. However, it might be worth exploring how various asset classes in your portfolio could be affected by possible future Fed actions, and whether there are ways to hedge your exposure to possible market volatility. If you've been keeping a substantial cash position, volatility also may present buying opportunities.

It's important to maintain perspective in the face of market turbulence. While you should monitor the situation, don't let every twist and turn derail a carefully constructed investment game plan.

*U.S. Treasury Department Resource Center, Daily Treasury Yield Curve Rates, retrieved from www.treasury.gov on June 21, 2013.

**Investment Company Institute historical flow data as of June 19, 2013.

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