First Trust
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The Fed's March Madness

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With two #2 seeds going down on the same day (Mizzou and Duke), and four Ohio teams in the Sweet Sixteen, March Madness is in full swing. Nonetheless, the Federal Reserve added to the madness last Tuesday when it released its latest assessment of the economy.

After months of living in denial, the Fed finally admitted the economy has improved, while, for all intents and purposes, it also took additional quantitative easing – QE3 – off the table. The best news was that the Fed ignored the ridiculous idea of "sterilized" bond buying, which it floated in the Wall Street Journal a week ago. We can assume that idea is now dead.

The impact on the markets was dramatic – stocks rallied, bonds got crushed, and gold fell again.

For several months, many analysts argued that the only reason to buy stocks was the potential of another round of quantitative easing. If the economy wilted, they thought, the Fed would ride to the rescue, so there was no reason to get too bearish. The "Bernanke put" had replaced the "Greenspan put."

We've been bullish for completely different reasons. We believe the recovery is real and sustainable and that profit growth will continue. We have also believed that stocks are undervalued. Yes, monetary policy has been accommodative, but monetary policy alone is not the driving force behind the bull market, profits are. We have never believed that Quantitative Easing (or the anticipation of QE) has driven stock prices up – if it had, price-earnings ratios would have risen, but they haven't.

The proof is in the pudding. As the odds that the Fed will embark on a new round of quantitative easing decline, the stock market has moved higher. Equity investors now realize they don't have to pray for more Fed ease to keep the bull running.

Bonds certainly got the message. The 10-year Treasury was 1.93% a month ago, 2.03% on Monday, and then closed at 2.30% on Friday. We see this as a sign investors anticipate the Fed will start to raise short term rates before the late 2014 date it wanted markets to believe.

The expectation of less Fed accommodation is why gold got hit, dropping $56 per ounce in two days. Gold is now 12.5% below its record close on Labor Day 2011. With gold still at $1659 as we write, gold investors are still speculating on a major wave of 1970s-style inflation, but the message from the Fed is that the monetary spigot will not gush forever.

Once the Fed finally realizes that economic growth and inflation are not following the Keynesian script, rates will move higher. This won't happen as soon as we would like, but soon enough to prevent the kind of inflation some gold investors have been hedging against. Gold bugs beware: gold prices are headed even lower.

What this means is that the best currency to be in over the next year or so is the US dollar. Yes, the Fed is loose, but everyone already knows that. It's priced in. The issue today is whether the Fed tightens policy faster than investors previously thought. And that looks increasingly likely.

Meanwhile, Europe's troubles are not over and neither are Japan's. Socialist European economies are making some improvements, but debts are still high and not every country can be saved with an aid package from abroad. The European Central Bank will face great pressure over the coming year to stay easy to help Italy, for example, and that means a lower Euro. In Japan, a political consensus is forming in support of higher taxes, which means more pressure on the Bank of Japan to stay loose.

Momentum is now shifting toward the US, with some global investors looking at equity returns sweetened by currency gains. Add higher US bond yields and emerging markets should be even more willing to buy US assets.

A self-sustaining, virtuous cycle is emerging, the kind that often forms in long-term bull markets. It's time to get on for the ride.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-20 / 7:30 am	Housing Starts - Feb	0.700 Mil	**0.695 Mil**		0.699 Mil
3-21 / 9:00 am	Existing Home Sales - Feb	4.600 Mil	**4.520 Mil**		4.570 Mil
3-22 / 7:30 am	Initial Claims - Mar 17	351K	**352K**		351K
9:00 am	Leading Indicators - Feb	+0.6%	**+0.6%**		+0.4%
3-23 / 9:00 am	New Home Sales - Feb	0.325 Mil	**0.325 Mil**		0.321 Mil