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Active Fed, conservative Congress to pave uncertain way

By Andrew Lecky
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Active Fed and new Congress to have uncertain effects Government and politics don't drive investments, but they do provide the road on which they travel.

The new Republican majority in the U.S. House of Representatives, coupled with highly active Federal Reserve policy that's designed to revive the economy, will make a difference in 2011. Yet based on history, the difference won't necessarily turn out the way everyone expects.

What everyone seems to agree on are interest rates.

"Investors should realize now that interest rates are going to stay low for a while," said Michael Ryan, head of wealth management research for the Americas at UBS Financial Services Inc. in New York. "The Federal Reserve is dictating policy at the long and shorter end of the curve."

The Fed's controversial recent purchase of an additional $600 billion of U.S. treasuries through June to try to reduce unemployment and avert deflation has been defended by Chairman Ben Bernanke as likely to boost growth through lower borrowing costs and higher stock prices.

"Down the road, there is going to be a day of reckoning in which all of this Federal Reserve easing of interest rates will have to be rewound, but it won't occur next year," said David Kudla, CEO and chief investment strategist for Mainstay Capital Management LLC in Grand Blanc, Mich. "The recent $600 billion quantitative easing by the Fed is the equivalent of a three-fourths of a percent point reduction in the Fed funds rate."

Congress is tougher to predict. Don't expect mega-changes. Market analysis by Fidelity Investments has found that in the period from 1950 through 2009, large and small-cap stocks performed better than average in the year after midterm elections -- but that the party in power hasn't made much of a difference.

In addition, there also has been little difference in stock market performance between periods of political gridlock and one-party rule.

UBS makes these investment-related predictions for the changed Congress in 2011:

• It will find common ground on a temporary extension of the Bush tax cuts, with a likely extension of one or two years. A permanent extension is unlikely to make it through a Democratic Senate and White House.

• While there will be considerable debate over how to reduce the federal deficit, the policy gulf between the parties is too wide for significant reform either by cutting spending significantly or by blocking health-care reform.

• It is unlikely to approve any additional large fiscal stimulus to boost economic activity.

• It will take a somewhat less activist role in regulating key industry groups.

But here's a reality check:

If the moves by the Fed and Congress don't make a dent in improving the nation's dismal unemployment figures, all bets are off. Those numbers must improve to the point where people become confident again about their personal balance sheets. This also affects the housing market, because only when they have that confidence will it be possible to reduce the inventory of unsold homes.