

Making Sense of the Signs

Wall Street doesn't watch economic indicators to see where the economy is today, but to try to figure out where it's going to be tomorrow. If an indicator comes out in line with market expectations, it causes no reaction. But when an indicator's results are unexpected, the financial markets do react—sometimes in seemingly contradictory ways.

Take the gross domestic product, or GDP. It represents the market value of all the goods and services produced in the country, thereby providing a measure of economic health. A weaker-than-expected GDP is bad news, for example. But it may prompt the Federal Reserve (the Fed) to lower interest rates to stimulate economic growth. Lower interest rates may be good news for stocks and bonds because they stimulate consumer spending—which boosts stock prices—and they enhance the value of existing bonds that pay higher rates. The result: a weaker-than-expected GDP sometimes causes investors to move out of short-term instruments, like cash, into stocks and bonds, causing those markets to rise.

On the other hand, the financial markets sometimes react badly to good economic news, like unexpectedly low unemployment. Why? Because a tight job market usually leads to higher salaries, which may force employers to raise their prices—and may ignite inflation. Wall Street fears that the Federal Reserve may then raise interest rates to head off that inflation.

When interest rates go up, consumers don't borrow or spend as much. That hurts corporate sales and earnings, and leads to lower stock prices. Rising interest rates are bad for bonds, too. The value of existing bonds falls because they pay less than new bonds. When interest rates are going up, investors prefer short-term investments and sometimes sell stocks and bonds, causing those markets to fall.

The lesson for qualified plan investors? The market's reactions to economic indicators are frequently short-lived and sometimes unfounded. For the long-term, buying and holding a well-diversified portfolio may be the best way to weather economic changes.

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