HELM INVESTMENT MANAGEMENT

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Good News is Bad News

When Federal Reserve Bank Chairman Ben Bernanke said last week that the outlook for the U.S. economy is beginning to get a little better, the financial markets gave a big cheer. A Bronx cheer.

Stocks, as represented by the S&P 500 index, dropped 1.3% in two hours after the Fed chairman spoke, then plunged another 2.5% two days later for good measure. The interest rate yield on the 10-year Treasury note has spiked to 2.58% as of June 25, up from 1.63% only seven weeks ago. The price of an ounce of gold plunged to $1,274 today from more than $1,600 in April (and more than $1,900 late in 2011).

The cause of these dramatic moves? The Fed began to signal last month, and Bernanke reiterated this past week, that the U.S. economy is growing healthier. That means the Fed can begin later this year to back away from its extraordinary program of buying billions in U.S. government bonds each month.

At a press conference Wednesday, Bernanke made it clear that he thinks this is excellent news. The change signals that the U.S. has avoided a depression and that the economy is gradually getting back to a normal pace of growth and job creation. Bernanke and many other economists regard the billions per month of bond buying as unsustainable – a practice that bloats the balance sheet of the Fed and crowds out other bond investors. He noted that now is a good time to let the economy stand on its own two feet. Housing is healthier. Prices of homes are up about 12% over a year ago, according to the S&P Case/Shiller index. Sales of previously owned homes rose more than 4% in May from a month earlier, according to the National Association of Realtors. Even employment continues to show gradual improvement.

Bernanke also emphasized at the press conference that the timing of the Fed's move away from quantitative easing in the form of bond buying depends on economic data, rather than on some timetable. If the employment picture takes a turn for the worse, Bernanke said, the Fed can step up the stimulus at any time. That's why the markets are set for a period when good news will be bad news for stocks – probably lasting at least through the summer. When good economic news lands, investors will assume the Fed will cut back even faster on quantitative easing. When bits of bad economic news hit, investors will hope for a return to Fed stimulus.

The economy and the financial markets have begun an important transition, akin to taking off a cast and beginning physical therapy after breaking an arm. The process might be a little bumpy and sometimes painful, but life will be better without the cast in the end. In the long run, good news for the economy really is good news for the stock market. And in the long run, what might seem like a frightening change now will look like a small blip for stocks.

Year-to-date price performance for the S&P 500 index (red line) and for iShares exchange traded funds for the Barclay's aggregate U.S. bond index (blue line), and gold (green line) show that while stocks have dipped, they still are having a much better year than other asset classes: