Federal Reserve Chairman Alan Greenspan grabbed headlines last week for his opinions on a variety of big-picture issues, from Social Security and tax cuts to budget deficits and the regulation of housing giants Fannie Mae and Freddie Mac.

But many investors are more concerned with the central bank's bread-and-butter issue -- setting the path for short-term interest rates.

Stock and bond markets right now "hinge on inflation fear" and whether the Fed and bond traders will go into "tightening mode," meaning rate increases, says James Paulsen, chief investment strategist at Wells Capital Management. Stocks should continue to rise through 2004, but only if bond yields and short-term interest rates stay stable, he says.

Interest rates influence stock prices because they affect the cost of corporate borrowing -- and therefore corporate profits. If rates go up, the cost of borrowing from both banks and bond investors rises. Investors also use rates to help them calculate the present value of a company's future earnings and cash flows. Higher rates make newly issued bonds more attractive to investors, who may switch out of stocks to buy them.

In recent weeks, investors have actually grown less concerned about a spike in short-term interest rates. Traders of federal-funds futures contracts expect a 25% chance of a rate increase by July, down from the 65% chance foreseen a month ago. "The widely anticipated rate hike will occur later rather than sooner," says John Lonski, chief economist at Moody's Investors Service.

Analysts say the Fed won't raise rates until job growth picks up more. Bond traders agree and have sent Treasury yields lower after a bout of indigestion last summer.
That kind of complacency worries Mr. Paulsen. He says that the declining bond yields and skepticism about inflation and job growth set up a scenario in which one or two surprisingly strong economic reports could spook the bond market, forcing 10-year Treasury yields to about 5% from their current level just under 4%.

That kind of jolt could raise costs for businesses as well as homeowners, possibly wiping out potential gains in the stock market in the process. Stocks are "probably going up until you get an inflation scare," says Mr. Paulsen. If the economy keeps growing at 4% and there's no inflation, they "will go up quite a bit." But inflation and rising interest rates would likely offset strong corporate earnings growth, keeping the stock market near current levels, he says.

Last week, the Dow Jones Industrial Average slipped for the second-consecutive week, despite rising 3.78 points, or 0.04%, Friday to close at 10583.92. The Nasdaq Composite Index lost ground for the sixth straight week and ended 5.8% off its January high. The index finished Friday at 2029.82, down 0.4% for the week. Despite the drops, the Dow, Nasdaq and other major stock indexes remain in the black for the year.

Stock-market bulls may have some reasons to hope for continued slow job growth. After all, the Dow has gained 34% over the past 12 months despite a job market that is limping along. That's because corporate restraint in hiring has boosted profits. But experts say job growth is needed to keep revenue and profits rising over the long haul.

Investors pessimistic about job growth have been betting interest rates will stay low for a while. Even though the Fed recently removed its pledge to keep rates low for a "considerable period" from its periodic statements, many Fed watchers expect Mr. Greenspan to remain patient before raising the key short-term target rate for the first time since 2000.

Indeed, Fed officials have made it clear that they are much less inclined to "pre-emptively" tighten monetary policy than in previous recoveries, because underlying inflation, at about 1% or less, is already so low. It is too low for some officials, who fear that another shock to the economy could push it into deflation, or generally declining prices.

"The Federal Reserve is in no rush to tighten" the rate from its 45-year-low of 1%, says Moody's Mr. Lonski. He noted that recent speeches by Fed officials indicate a willingness to keep rates low. They want "to keep the punch bowl full, which can only have positive implications for profitability and stock-price performance," he says.

Mr. Lonski doesn't expect interest rates to move higher until payrolls grow by 150,000 a month for three consecutive months. The past three months mustered average growth in payrolls of only 70,000, he adds. The presidential election this fall also "will encourage the Fed to proceed all the more cautiously" in raising rates.

But that doesn't mean traders think bond yields and rates will stay low indefinitely. Nearly 40% of large bond investors surveyed by J.P. Morgan last week were betting on yields rising, while only 14% thought they would fall further. Nearly half of investors surveyed said they were "neutral," or had no bet on rates.

"Rates are still going to head higher, but they'll do so from a lower level," says David Resler, chief economist at Nomura Securities. Mr. Resler predicted several weeks ago that the 10-year Treasury yield would approach 5% by the end of this year. But he has lowered that forecast to about 4.75%
based on the recent performance of the economy and job market.

One of the crucial questions in the interest-rate outlook is whether inflation could take off without job growth, putting pressure on the Fed to raise rates. Mr. Paulsen says he is concerned that increasing prices on commodities such as oil, lumber and metals will eventually filter through to consumers. Another threat is that a weak U.S. dollar could lead to higher import prices.

"I've got to admit this isn't happening yet," but if inflation does return, "the story could turn bad for rates," the strategist says. Rising inflation would likely force a selloff in bonds, sending long-term and intermediate-term Treasury yields higher. At that point, "the bond market could care less about jobs," Mr. Paulsen says.

To be sure, inflation could continue to stay under control as it has been for years, thanks to global influences such as outsourcing and technology-led productivity gains. But "the Fed may have a dilemma," if inflation and long-term interest rates pick up without stronger job growth, Mr. Paulsen says. Fed officials don't want to raise rates before jobs take off, but they also don't want to be "accused of thwarting the free market" and ignoring long-term bond yields.

Mr. Paulsen has lots of company in thinking interest rates will rise, but not in his prediction that long-term rates will rise sharply -- to 5.5% by the end of the year -- with the fed-funds rate also shooting up to 2.5%.

Indeed, while more investors think rates are going up than down, those feelings are weaker than they were at the beginning of the year. The percentage of investors in J.P. Morgan's survey who had placed their bets on falling bond yields has increased to 14% from 0% on Jan. 5, while the percentage betting on rising rates has decreased to 39% from 41%.

If rates do move higher, stock investors are likely do better picking large companies in economically defensive sectors that could continue to see their earnings rise despite the headwinds of higher rates, Mr. Paulsen says.

"Investors should be very aware and cognizant of interest rate hikes later in the year," says Mr. Lonski. "But it remains to be seen if they can rise steeply enough to dent economic activity."

Friday's Market Activity

The Dow Jones Industrial Average clutched to a gain on the final trading day of February, as United Technologies and Boeing rebounded and U.S. economic growth defied expectations.

Leading the blue-chip advance, United Technologies rose $2.23, or 2.5%, to $92.11, and Boeing climbed 93 cents, or 2.2%, to 43.37, retracing part of a slide that began earlier in the week when the Army said it would abandon the Comanche helicopter program.

There were some notable decliners on Nasdaq, including Genzyme. Shares fell 2.83, or 5.3%, to 50.45, after the biotechnology firm agreed to buy small-cap Ilex Oncology for $1 billion in stock.

-- Greg Ip and Cynthia Schreiber contributed to this article.

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POWERFUL WORDS

Alan Greenspan's Federal Reserve makes headlines—and moves markets. Since June 2003, the Federal Open Market Committee has cut its target federal-funds interest rate just once, by one-quarter of a point. But the markets have responded as much to the FOMC's words as to its deeds.

Jan. 28, 2004 The FOMC's language changes: "With inflation quite low and resources use slack, the Committee believes that it can be patient in removing its policy accommodation." 5.50%

June 25, 2003 Lowers interest-rate target to 1%, and says a fall in inflation is a bigger concern than a rise for the foreseeable future. 10-year Treasury note yield (right axis) 5.00%

Aug. 12 The FOMC worries about the risk of "undesirably low" inflation and says it "believes that policy accommodation can be maintained for a considerable period." Dow Jones Industrial Average (left axis) 4.50%

Feb. 11 Greenspan tells Congress that the economy is managing its expansion in a way that will not oblige the FOMC to raise rates soon. 3.50%

Sources: Thomson Datastream: Federal Reserve

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