When rates hit rock bottom...

Two weeks ago the GDP report showed virtually no growth in the first quarter. Interest rates should be falling in a weakening economy, at least in theory, but they rose to a two-month high.

How can that be? I'll explain.

I've made the case that there is no reason for the Fed to raise interest rates.

After all, economic growth is disappointing, inflation is tame, and rising rates would move the dollar even higher.

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Market Pulse

Those points remain valid, but the surprising move higher in rates says something else may be at play. Here's one theory:

The Fed members may be pondering whether near-zero interest rates are the right policy or even an effective one for the economy.

After all, we've had near-zero rates for more than five years.

In theory, when rates are rock bottom, investors save less because returns are low, consumers spend more because financing is cheap, and business investment increases because corporations have a lower cost of capital. In theory.

What has happened is something else. Yes, stocks and bonds have risen (hooray!), but wages have been stagnant, savings are up, spending and investment are lackluster, and growth is anemic.

In short, the wealth effect has yet to appear, and if it hasn't by now it probably won't. Again, there are theories and ivory tower economists. Then there is the real world.

The rise in rates led to selling in Treasuries, lower-yielding corporate debt, and utilities. Treasury bond funds and utilities are down 11 percent since January.

So much for those "conservative" investments.

With a few exceptions, most of the preferreds that I've written about are about unchanged.

My favorite, HSBC USA Adjustable Rate Series D, reached a new high even as rates were rising.

It traded below par when I wrote about it in 2013 (4/18/13, 6/6/13, 12/12/13). Now it is well above par.

Of course the Fed controls short-term rates and the market controls long-term rates. The market may be responding to or anticipating an uptick in inflation. We can see that in oil prices.

Still, it's hard to imagine that rates will rise by much. There is little reason for it. As long as rates remain low, stocks will do well.

The biggest factor behind the market's strength is that the alternatives aren't attractive. That won't be changing anytime soon.

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