Rohr-*Blog*

2016/03/23 *Commentary*: Fed's 'Normalcy Bias' Crumbles

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***COMMENTARY (Non-Video)*: Wednesday, March 23, 2016 (late)**

Fed's 'Normalcy Bias' Crumbles

The Fed has no Cred!! The Federal Reserve's credibility is reaching new lows with most of the US and global financial community in the wake of recent significant shifts in policy and communication. More on that below, but first a reminder of something we first noted back in our November 22, 2013 *Commentary: It's the Fed PR, stupid (http://bit.ly/1UpNGHy)*:

"*Over the past 30 years central bankers have gone from inscrutable to insufferable*."

At the time there was a lot of divisive discussion of when and how the Fed's famous Quantitative Easing (QE) taper would take place. Yet more than two years later it is not only no different on the extremes that are being reached on the potential for further FOMC rate hikes, in its way it is far worse. First there was the Fed's 'normalcy bias' that left it far too hawkish after the first rate hike in almost a decade back on December 16th (see our post that day for more.) That led to last week's major *volte face* on the likelihood of only two rate hikes in 2016 instead of the four that it had signaled prior to then.

Yet this week there were countervailing hawkish opinions, and even a flip-flop by one of the typically hawkish Fed minions who had been more dovish of late. The former was the new Philadelphia Fed President Patrick Harker, and the latter was New York Fed President William Dudley. We suppose that Mr. Harker should have been expected to carry on the traditionally hawkish view of previous Philadelphia Fed President Charles Plosser. But Mr. Dudley had only recently been one of the main proponents of more gradual rate increases in the context of global economic weakness. That's a real flip-flop.

And both of them are now saying the April FOMC meeting is 'live' as a potential rate hike horizon. We suppose if one now believes Mr. Harker is right that not two but three hikes are still likely this year, the April meeting would need to be 'live'. Yet this all creates more confusion on not just the most likely action by the Fed, but also whether it actually has any idea what it is doing? That is not just on policy, but also on perception it is the 'steady hand on the economic tiller' that it always claims is part of its benefit to the economy and society at large. These rapid fluctuations that are reflected in immediate 'risk-on' and 'risk-off' market reactions can't be good for mainstream business investment confidence. After all these years of the Greenspan and then accelerated Bernanke 'transparency' drives, how much more do we know now than when the central banks were opaque?

While we review quite a bit else, the comparison between 2016 and 2007 when Fed action also could not save the world is near the end. And we remind everyone:

The next financial crisis will occur when the investment and portfolio management community (and ultimately the investing public) realizes that the central banks alone cannot restore the robust growth from prior to the 2008-2009 financial crisis.

NOTE: **Back on the evening of December 8th we posted our major Extended Perspective Commentary. That reviews a broad array of factors to consider *Will 2016 be 2007 Redux?* For many who believe that the US economy is really strengthening and can once again lead the rest of the world to more extensive recoveries, this may seem a bit odd.**

Yet there are combined factors from many areas we have been focused on since the early part of last year which are less than constructive for the global economy and equity markets. We suggest a read if you have not done so already.

We pointed out in December in the face of another likely Santa Claus Rally this was not an actionable view during the year-end equities rally. Yet it was (and remains) important background to utilize into 2016. This is much like our major late 2006 perspective on *Smooth Rebalancing? …or… The Crash of '07?* (http://www.rohr-blog.com/documents/freearchives/CMOII-48.pdf), (even though the actual crash was deferred into 2008.)

The 'Normalcy Bias' Crumbles

It had to happen sooner or later. In the event it was sooner that the Fed's 'normalcy bias' fell by the wayside. After such adamant insistence that the return to 'normal' conditions would warrant another four rate hikes in 2016, the capitulation in FOMC projections (the 'dots') released exactly one week ago today was striking in several ways.

First of all was the speed with which it happened. Maybe in micro-analytic terms exactly three months to the day after the FOMC hiked the Federal Funds rate for the first time in almost a decade is a long time. Yet in terms of the typical expectation for the longevity of a central bank forecast and action, it was both as rapid and extensive a *volte face* as we've ever seen.

Of course, this is merely an extension of how out of touch the original FOMC position was back on December 16th. We had already alluded to it in our major perspective earlier in December, repeatedly noted in the highlighted section (above) in all recent posts. Yet it was still worth naming our December 16th post-FOMC announcement, (misguided) projections and press conference analysis *Fed's 'Normalcy Bias' Continues*. That's right, it was exactly three months to the day prior to last Wednesday's FOMC meeting.

And the other closely related implications of the extent of the Fed's reversal are the degree to which it is indicative of just how much the US economy is being affected by global economic weakness, and one other very interesting factor:

In what is a completely different context, the US central bank psychology and the equity market response are very similar to another highly volatile topping-out phase prior to a bear market. They work hand-in-glove, and we will be sharing quite a bit more on that below. That will reinforce how these sorts of major rallies back above what would seem to be obvious DOWN Breaks and other technical resistances are very typical during the death throes of extended bull markets. The fundamental key is whether the underlying economics can support the reinvigoration of the bull trend to post the requisite extensive new highs. We shall see. Yet here is what we know…

So is it 2007 or 2008?

While the year began in a manner that potentially indicated the US equities had jumped right past the broad topping activity that took hold from mid-2007 into mid-2008, the overall activity now does indeed more so resemble the beginning of the top in 2007. While the US equities are behaving much better than the worst case possibilities had the Fed maintained its 'normalcy bias', this is still consistent with the why and how of bull markets topping out into a major correction.

Both in 2000 and again in 2007 the US equities saw major recoveries that seemed to reverse the bear market potential, only to fail again into significant weakness as the major trend evolved. In fact, the similarities in the central bank and technical trend psychology between 2007 and 2016 are striking (even if other fundamental background is significantly different.)

The revised FOMC future rate hike projections amount to a forward looking 0.50% easing of expectations. This has fits in with the current US equities rally, and that major historic context of how the last major equities top evolved. Even with the more recent rumblings from Messrs. Harker and Dudley, everyone knows the Fed is back to being fully data dependent. So for now the 'bad news is good news' psychology will likely maintain.

And that is why it is important to revisit that recent volatility implication research.

The Same Old Song

What we are about to explore is known to experienced portfolio managers, traders and analysts. It requires a clear vision of the fundamentals having degraded from the previous bull market drivers, and also the ability to view recovery rallies with some skepticism in spite their magnitude and length.

We begin by sharing a bit of our long term personal experiences. One of the advantages of macro-technical analysis is the aggressive review of both technical trend considerations and the fundamental drivers of the overall trend. And there are those times when the significant rallies back from the initial sharp selloffs in a bear market look very good. However, within an overall Evolutionary Trend View (ETV) that is the point where the in-depth review of the fundamental (macro) factors is essential.

This was the case back in 2000. The tech sector had driven the broader rally, as many folks bought into the idea that due to technological innovation, "It's different this time." Experienced analysts and portfolio managers know just hearing that phrase is enough to question the market assumptions. When the unsustainability of the Dot.Com Bubble era earnings for the highflying tech stocks became apparent into the spring of 2000, it was all over except for the actual trend evolution. That included a lead contract S&P 500 future recovery from April's 1,367.50 low all the way up to summer highs in the low 1,500 area.

That was back near the all-time trading high at that time of 1,574 set in March 2000. However, the subsequent failure below 1,367.50 led the overall bear market phase selloff that did not bottom until 767.50 in October of 2002. The similar situation based on overconfidence that the Housing and Credit Bubbles could sustain additional economic growth and equities gains occurred once again throughout 2007 into mid-2008. Yet there

as well the initial downside volatility into August 2007 was a harbinger of the bear market taking control of the trend.

Current Academic Volatility-Timing Insight

And courtesy of the FT is some important *new academic research on that tendency*. As regular readers are well aware, John Authers is one of our favorite analysts at the Financial Times. He consistently delivers outstanding perspective and insights, often incorporating the latest research in key economic and investment areas.

In his March 9th '*Reassessing the classic risk return trade off'* column he shared one of those new academic insights referenced above on what significantly higher sustained volatility really indicates for the equites. From that column (not necessarily in order):

"'If you can keep your head when all about are losing theirs, it's just possible that you haven't grasped the situation.' That was how the American satirist Jean Kerr updated Rudyard Kipling's poem, and new financial research suggests she was on to something.

"It also adds to the growing supply of data suggesting we should reexamine the traditional financial view that investment is about trading off risk and return, with greater risk ultimately rewarded with greater return.

"According to new research by Alan Moreira and Tyler Muir, two academics at Yale University's School of Management, the correct response to an increase in volatility — and with it, risk — is to exit the market. The time to reenter is only when the volatility has already started to subside.

"And it also rather worryingly contradicts the widespread belief, based on much research, that higher volatility creates a great opportunity for brave contrarians to buy at the bottom.

"During the most famous US market breaks, the volatility-timing portfolio led the market at all times, avoiding much of the savage drawdowns seen after the 1929 Great Crash, and during the 2008 Great Recession."

You can read our highlighted version of that article (http://bit.ly/1PvNXQS) , and we also suggest accessing Mr. Authers' full column on FT.com (http://on.ft.com/1RkGITl) for access to additional related articles. For those of you who do not already have a Financial Times subscription we suggest taking advantage of their very generous trial offer.

It is most interesting whenever academic research tends to reinforce the perception of extensively experienced participants in any field. Yet that is sometimes even more so the case in the financial markets, because they are intrinsically so psychological. In this case we applaud the Yale University researchers who have quantified insights that many in fact assist both professional portfolio managers and the investing public with identifying those times that it is prudent to raise cash rather than attempt to reap greater reward just because of greater volatility.

Limits of Central Bank Powers

Negative rates are the end of the (very distended) line.

They were initially hailed as the next bold moves when first the BoJ and then the ECB pushed the ultimate extension of major central bank rate accommodation with Negative

Interest Rate Policy (NIRP.) That even superseded the Fed's long-standing ZIRP (Zero Interest Rate Policy), which had not really seemed to be constructive after quite a few years. Yet the downside of moving into negative territory soon surfaced.

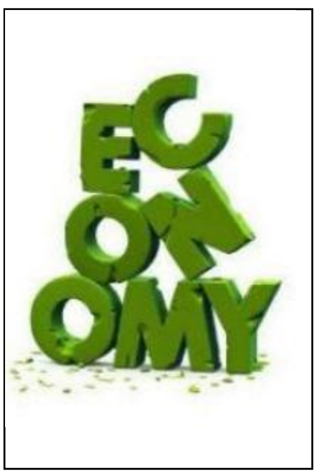
In the first instance, after a very fleeting weakness of the Japanese yen into the BOJ move back on January 29th, it immediately reversed in early February to greater strength against the US dollar than at any time since November 2015. And along the way USD/JPY left a 1.1620 major weekly channel DOWN Break (as we have noted in all recent Market Observations.) That runs counter to the desire of the Japanese government desire to see the yen weaken to stimulate exports.

On the interest rate spreads, it is also counter to the overall health of the very important financial sector in each country due to the lack of profitable spreads. From the March 10th Financial Times article on *Senior European bankers voice concerns over ECB cut* (http://on.ft.com/1RlUbr4), "*Bank leaders are alarmed by the crippling effect on their profits of negative rates which they cannot pass on to ordinary customers, adding to concerns about the fragility of financial stability in some parts of the eurozone*."

Andreas Treichl, chief executive of Austria's Erste Bank and the longest-serving chief executive of a major European bank, said, "…*the ECB's 'limits have been reached' after years of ultra-loose monetary policy that has failed to lift inflation to anywhere near the ECB's target of 'close to but below' 2 per cent*."

Of course, he's right. As we have pointed out more aggressively since early last year, the central banks are fairly passive co-dependent culprits in the real financial crime: the politicians of most countries failing to negotiate and implement the structural reforms necessary to make the quantitative easing and low rates effective. And as we have also repeatedly noted, the US is the worst offender. The country that used to lead the economic cycle has a political class that is so ossified by its counterproductive partisan quarrels that no effective structural reform has even been discussed for many years.

While cuts from higher interest rate levels provide hope businesses will be inspired to invest and hire. Yet the weight of the US fiscal situation along with over regulated healthcare, environment, finance and other areas has suppressed the typical animal spirits. The early hopeful moves on rates and quantitative easing were in fact enlightened. Preventing a further meltdown in 2009 was to Mr. Bernanke's credit.



A Wealth of Negative Factors

There is already so much we've discussed on factors like still overly optimistic corporate earnings and the pernicious historic implications of the continued major drop in world trade in our *Equities' Goldilocks Psychology* post (March 5th) and the subsequent *Equities Still a Major Bear* (March 16th) we are expanding upon here, we simply suggest you revisit those. Obviously the 'Goldilocks' posts begins with the friendly influence of the sense data was weak enough even back then to indicate the Fed's 'normalcy bias' would likely be reversed at some point… which we saw at last week's FOMC meeting.

The one thing that is still worth noting is this month's OECD (Organization for Economic Cooperation and Development) Composite Leading Indicators (CLI) (http://bit.ly/1Xck7GQ) from back on Tuesday March 8th. What was striking about the previous CLI in February

was the additional weakness in the US, UK, Japan and Canada even if China seemed to be attempting to stabilize from already depressed levels. However, among the most interesting indications was the general expectation of further growth in Europe even though Germany seemed to be turning back down.

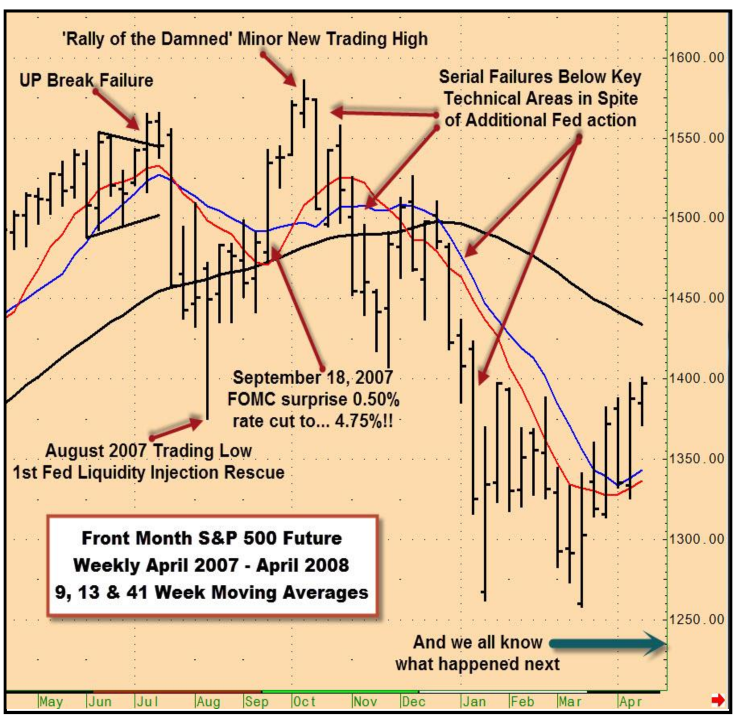
Well, this month's CLI reinforced that downturn in Germany, which in turn not surprisingly weakened the overall reading for the Euro-zone. There was also further evidence of the outlook darkening for the others as well, especially the US and Japan with not much of any improvement in China either. But don't take our word for it, as you can take a look for yourself. And suffice to say for the typically ‘glass is half-full’ folks at OECD to give this month's release the headline *Signs of easing growth in the OECD area* indicates just how negative things must feel to them.

How Does All This Make 2016 and Analog for 2007?

Keep in mind that last Wednesday’s FOMC projections adjustments were in practice a forward looking 50 basis point rate cut. And even we must admit the return to a ‘bad news is good news’ psychology might well allow the equities to churn higher for a reasonable amount of time before enough ‘bad news’ makes it indeed, well, bad news again.

And if we review the 2007 tendencies in that context against the recent price activity, it seems eerily similar. Of course, that does not guarantee the sort of broader bear phase that we are currently projecting. That is for the front month S&P 500 future to correct down to the 1,500 area, give or take $100.

While that might sound fairly radical, it is of course quite a bit less of a major correction than occurred in either 2000-2002 or 2007-2009. And if the S&P 500 continues to fail on rallies in spite of central bank accommodation attempts to stimulate the global economy, then it will most likely spell trouble by later this summer.



Here is that comparison in as tight a nutshell as we can accomplish. This is all based on the front month S&P 500 future. [For an enlarged view of the annotated 2007-2008 S&P 500 weekly chart just click on it with a mouse or tap it on a touch screen and it should open in a new browser window.] In July-August 2007 there was extensive weakness after a new minor new high ended up more of a false Triangle UP Break than a harbinger of the next bull market extension. The bottom of that selloff into mid-August accelerated in a way that fomented the first Fed intervention. Yet that was in the form of a liquidity injection to sooth what was

considered just a modest interbank dislocation at the time. Many who were skeptical of housing finance market stability suspected it was something more.

The Fed's nerve soothing move was enough to restore the bull sentiment at that time. In recent times the market has experienced the entire August Chinese currency adjustment and mid-September hawkish FOMC selloffs, the latter was reversed once the economic data remained weak enough into early October (including an abysmal US Employment report) that US equities began to anticipate the Fed would not actually hike in October.

And they were right. Yet this was not an overt move by the Fed, but rather forbearance. And in any event, the US equities that were (both then and now) supporting other global equities which had less constructive data had the year end Santa Claus (or Santa Portfolio Manager as we prefer) Rally to look forward to. That really reset the entire trend to feeling like it had not yet made a major top.

As such, the real indication an overall top might have formed was not apparent until (as we had repeatedly warned) after the Santa Claus Rally lapsed at the end of the year. And the sharpness of that selloff was impressive. For the front month S&P 500 future to drop back below 2,020-10 all the way to the low 1,800 support (for a modest new low) in two-and-a-half weeks was impressive. And for the major volatility to be on the downside twice in five months does not bode well for the bull. And to reinforce that, even bullish analysts have noted the significant lack of volume on the current recovery.

Recent Events Even More Similar to 2007

At least we must consider that as a scenario on a prospective basis. The August 2007 sharp 1,375 trading low was driven by the degree to which the assumptions on the market prior to the interbank market illiquidity scare were all bullish. I actually appeared on CNBC that Monday morning (August 13th) and scared the heck out of the still relatively inexperienced Becky Quick by suggesting the technical trend support in the DJIA (then at 13,200) could be as far down as the 12,500-12,000 range.

And I further noted if it got near there in a hurry the Fed would need to move to prevent a market dislocation. It ended its selloff down at 12,517 before the Fed came in Thursday to foster the sharp Friday recovery you can infer from the S&P 500 chart. Given the tendency for CNBC to be a pure 'market perma-bull' cheerleader back in the day, the producers did ask me back to follow up on my analysis.

As it relates to the present, we would consider the basing from the low this January as similar to what would have transpired from the August 2007 had it not represented such a panicky market. Here we are at present along the way on a rally that is driven in part by the understanding that while things are not great out there, the central banks (even the Fed) are likely to be accommodative.

After all, the central banks providing all of those lower rates and extensive balance sheet expansions have managed to drive 'risk-on' psychology. Isn't that just going to work again? For the negative response to that we refer to *Limits of Central Bank Powers* section above. The govvies response to more hawkish Fed comments of late speaks volumes.

Yet back to the comparison, it was the September 18, 2007 surprisingly large FOMC 50 basis point rate cut to the unthinkable 4.75% level that spurred renewed hope of the

continuation of the bull market. [And viewed with the benefit of hindsight, how outrageous is it that at the beginning of the Credit and Housing Bubbles bursting the investing public and professional portfolio managers thought that a 4.75% Federal Funds rate would address the problem?]

Of course, it did nothing of the sort. In fact, those who were sure the Fed was becoming very 'easy' managed to but just enough equities to foment the 'Rally of the Damned' final minor new trading high at the onset of one of history's greatest bear markets. Yet what is also important is that 2007 and 2016 price swings are five months out of synchronization. It was August in 2007 and January in 2016. So what's the relevance of that?

Easy, it is the enhanced bearish potential due to the seasonal factor. But fist, that also works with the timing of the September 2007 FOMC rate cut. As we have noted in previous research, the future 25 basis point rate hikes expected this year in last week's FOMC projections were down from four to two; and on the basis of the market being a 'creature of expectations', that is equivalent to a *de facto* forward looking 50 basis point rate cut.

So along the way on a recovery from a low in August 2007 the FOMC provided a 50 basis point rate cut. Along the way from a low in January 2016 the FOMC provided a *de facto* 50 basis point rate cut. When did the S&P 500 and other equities top out in 2007? November, three months after the August low. What is the equivalent in 2016?

April. There are also a raft of central bank meetings at mid-month which might bolster the global equities. Yet the last great hope for equities is likely the FOMC straight statement (no projections or press conference planned) on April 27th. And if the economic data and/or corporate earnings remain weak, it is hard to imagine the FOMC will in fact raise rates at that meeting, even if the hawks demand it continues to threaten to do so.

Even so, if earnings are indeed as weak as some suggest (see the *Looming Earnings Problems* section in our *Equities' Goldilocks Psychology* March 5th post), the Fed's forbearance might not really amount to much… except the further reinforcement for the central banks need to remain accommodative because things are not so good out there.

So we have an analog for the three month rally from the August 2007 to the high in November of that year. It is the rally from the January 2016 low up to the April high. It that a definitive analysis? Nope. But it is a reasonable assessment of how the current very different overall situation might relate to the current reasonably likely topping activity.

And that is reinforced one other very negative factor which fits in with the expectation it might be a three month rally from the trading low once again prior to the start of the bear.

Seasonal Factors at Their Worst

First of all we should note that we are not big fans of putting too much emphasis on seasonal factors as a primary influence. When any strong trend is driven by other factors, the seasonal gets overrun. However, when a seasonal tendency reinforces the prevailing trend, it can mean that trend is more forceful. And the seasonal coming into April is at first encouraging, and then a real negative… especially on the extended trend anticipation.

The early part of the month tends to be very firm on upbeat corporate quarterly earnings report anticipation, and then top out some time after they are released. This year will be very important in that regard in light of expectations for some sectors to show diminished earnings. Yet lurking in the background is the classic adage, "Sell in May and go away."

Combine that with the fact that in US election years April tends to underperform in any event. As the other old cliché goes, "The market dislikes nothing quite as much as uncertainty." And if an election cycle ever indicated a lot uncertainty, it is this year. The Socialist is losing out to the national security felon, while on the other side the Senator his colleagues all hate is trying to catch up with the big-mouthed, bombastic neophyte.

And just to put a bit more flesh on those "Sell in May and go away" bones everyone is so familiar with, consider this. The semi-annual assessment beginning with May confirms the unfavorable tendencies that gave rise to the cliché. Compounded 65 year May-October performance on a $10,000 investment is essentially break-even: a loss of a $221. That compares with an eye-popping $838,468 November-April return for the same period.

And that election year tendency is terrible. While the DJIA and S&P 500 are normally ranked 9th and 8th respectively for performance in normal years, in election years they are each ranked 11th. And that is at the start of a typically poor six month period that has little chance to improve this year until at least closer to the US election.[1]

[1]Seasonals courtesy of Stock Trader's Almanac 2016 ©2015 John Wiley & Sons, Inc.

Conclusion

All in all it is a fairly weak outlook, and it will be very interesting to see if the FOMC and Chair Yellen continue to back off further from the aggressive projections and future rate path indications in December's major FOMC meeting and press conference. As noted above, even if it does so, the economic data and corporate earnings are going to remain the more crucial influence.

The Fed and the other central banks are now trapped in a prison of their own devise… and unfortunately for them (and the rest of us) the political class still holds the key. Without some meaningful structural reforms that are unlikely to be forthcoming during the intense US political season, the impetus for enough corporate investment to resurrect the global economy is not likely to be forthcoming.

Extended Conclusion is available below.

[Usually only available to Gold and Platinum echelon subscribers.]

Extended Conclusion

Wednesday, March 23, 2016 (late)

As we have noted on many previous occasions, the real answer lays with the political class that has convinced itself the central bankers can resuscitate growth instead of the classical (and ultimately more accurate) need for structural reform. That is the other reason the central bank focused US equities (leading the other to some degree) 'Goldilocks rally' remains less than convincing in spite of the extent to which the equities can rally in the near term.

Ultimately the bears are still lurking in the woods. Exactly when and how they might re-emerge always tends to be a matter of watching for particular types of market activity in the context of the near term news and economic data. That can almost never be specified to a high degree in advance.

Yet we repeat our previous admonition once again:

The next financial crisis will occur when the investment and portfolio management community (and ultimately the investing public) realizes that the central banks alone cannot restore the robust growth from prior to the 2008-2009 financial crisis.

That has indeed become a keynote of some of the more significant recent market turns, especially a lack of follow through at points where the Federal Reserve seemed to remain accommodative, like into the end of last year

It all remains very fraught, and once Goldie is done on this go round we suspect the result will be very similar to the aftermath once Santa Portfolio Manager was done bolstering the equities in December.

Extended Trend Assessment

We refer you to the Market Observations in Tuesday morning's Global View TrendView video post that were updated Wednesday morning. They remain the relevant view in light of very little further trend evolution today after they were posted. While there has been some market movement, it is all consistent with the assessment in those Observations.

Thanks for your interest.