MARKETS

Good news: Fed plants seeds for rational markets

BY DANIEL P. COLLINS

Bonds and equities oddly have been joined at the hip of late, but a less active Fed could be the key to these asset classes returning to normal, and for markets to react to fundamentals instead of how the numbers affect Fed policy.

U.S. equity and fixed income markets had what best can be described as a temper tantrum in May and again in June after the Federal Open Markets Committee (FOMC) intimated that the Fed may before the year is over reduce the amount of direct bond purchases it makes each month as part of the third round of quantitative easing (QE3).

QE3 tapering
Stock & bond correlations

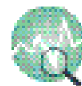
Both fixed income and equity markets dropped dramatically, which appeared to be an overreaction as there was no commitment, as some had suspected, to "taper" QE3 this summer. In fact it was only in Fed Chairman Ben Bernanke's press conference that he indicated the Fed would begin to reduce bond purchases before the end of the year and pare them down to zero by mid-2014, all with the qualification of economic numbers permitting.

The Fed's statement didn't seem so extraordinary given the slow but steady growth in the economy, but the markets have grown accustomed to their $85 billion fix each month and reacted violently to the thought it would be taken away.

Many analysts believe the market overreacted to the news but also think it could be the beginning of a more rational market that reacts to the actual economic numbers, and not necessarily how those numbers will affect Fed policy. Typically, bonds and stocks are non-correlated and often negatively correlated, as bear equity moves often would create a "flight to quality" into bonds. But the Fed's quantitative easing policies have changed that dynamic (see "Strange bedfellows," right). "The old conventional wisdom years ago was that when equities went up bonds went down and vice versa," says Randy Frederick, managing director of trading and derivatives for Charles Schwab. "But that hasn't always been the case; it certainly hasn't been the case since the Fed began intervening back in '08."

Andrew Wilkinson, chief economic strategist for Miller Tabak & Co, notes that the Fed did a "very clever thing. The market was frightening itself ahead of every data point because it feared the Fed would taper. The Fed now has put the onus back on the data to prove that it should taper. So investors should no longer fear strengthening economic data."

Matthew Buckley, CEO of Top Gun Options, calls this a bizarro market. "It is kind of like the movie 'Blazing Saddles' when the sheriff puts a gun to his own head; they said 'he is crazy enough to do it.' That is what the stock market is doing to Bernanke."



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Others, however, believe the market reacted logically and see more pain ahead. "I don't think the markets overreacted," says Alan Bush, senior research analyst for ADM Investor Services. "It reacted as it should have because this is a change in policy and contrary to what [Kansas City Fed President Esther] George said, a tapering is a tightening, it is a change in their policy."

Bush also points out that the Fed's hand was forced by rising bond yields prior to talk of tapering. "U.S. interest rate yields are increasing in spite of the $85 billion in monthly purchases of bonds, so the bond market is saying it does not want to see additional bond purchases. They are not getting what they want from QE." (See "Bonds started this," right.)

While some may argue over the origin of the bond sell-off, everyone agrees equities are following rates. "What is wrong with the equity markets? The answer is the bond market," Frederick says. "The bond market, from a notional value standpoint, is a whole lot bigger and is

a lot more global. With this kind of an interest rate rise since the beginning of May, there is no question that this is a much bigger factor in the equities markets than it normally is."

Bush also is not convinced that the end of QE3 will bring a return to more rational markets. "When the Fed had their unlimited QE, the bad news on the economy was bullish because it meant they needed more QE; good news was bullish because it meant QE was working. Now it is the opposite, bad news is bad news because QE isn't working and the good news is [bearish because] they have latitude to scale back."

Harold Lavender, a former Chicago Board of Trade director and member of the New Mexico State Investment Council, agrees. "It may be the reverse [of what we have seen], the fundamentals may look better, but the market is not going to go higher."

Buckley says, "I told my traders there were three taper scenarios: The good, the bad and the ugly: The good was the Fed is getting out of the way because the economy is great and it is a smooth baton hand off, that didn't happen; the ugly was the Fed just would leave because they are creeped out about what they're doing; the bad — which is what we got — we are kind of creeped out about what we are doing and the economy is kind of good. Of the three, we got the worst choice."

Wilkinson, however, expects volatility to curtail if the Fed remains firm. "Fed speakers will continue to deliver the Fed's message until the child stops throwing the rattle out of the crib," Wilkinson says. "At some point, and I don't know when this will be, stock prices will divorce themselves from rising bond yields and at the same time bond yields will stop rising so aggressively. My underpinning argument there is the absolute lack of inflation. I still think that despite Bernanke's discussion of easing off on the bond purchases, we are an awful[ly] long way away from the time that official interest rates go up. So a lot of the fear in the market at the moment is likely to calm over [the] coming weeks and months."

Where are bonds headed?

Bonds have fallen precipitously since the beginning of May, especially considering there has been no tapering and the Fed still is committed to purchases through mid-2014. "If you look at an 86-basis-point move in the 10-year, that is sharp. I can't imagine that rate of change continuing, that doesn't seem possible, especially without the Fed being willing to raise rates," says Frederick. "The bond market

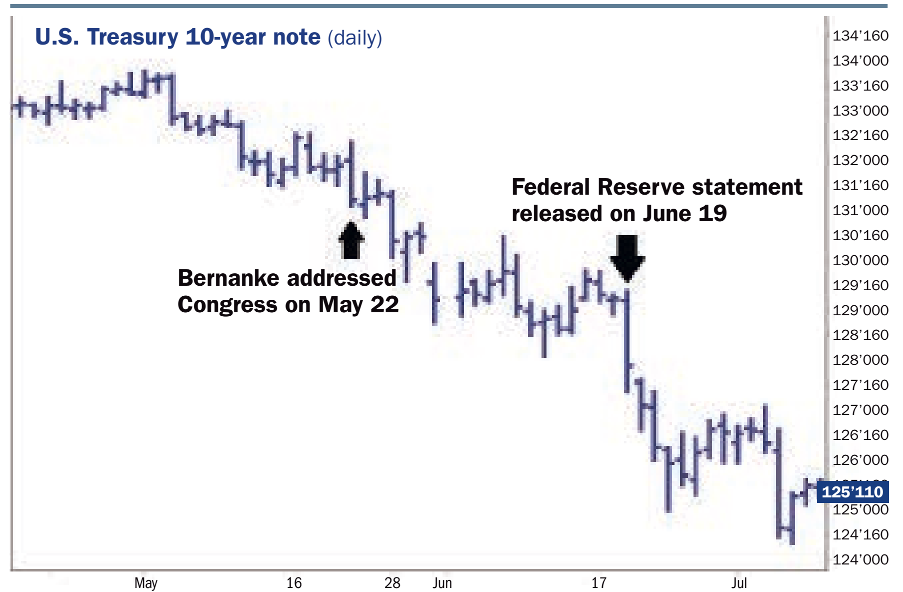
STRANGE BEDFELLOWS

Historically, bonds had been a safe haven in bear equity markets. But since the Fed has initiated various quantitative easing strategies to hold long-term rates down, it also has served to support equities, changing the dynamic between the two asset classes.

Source: eSignal

BONDS STARTED THIS

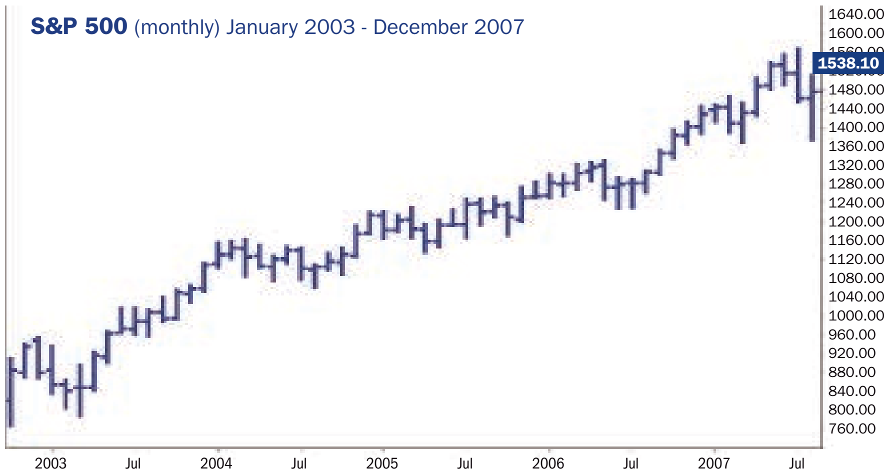
While Fed Chief Ben Bernanke's testimony before Congress on May 22 is credited with the start of this downturn, Treasuries already were heading down, leading ADM's Alan Bush to believe that QE3 just was no longer effective.

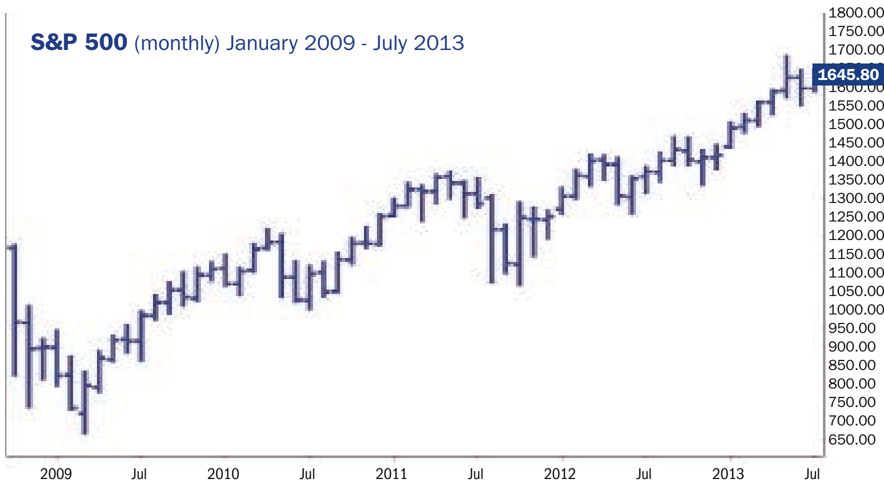


Source: eSignal

REPEATING PATTERNS

The current bull market in equities is very similar to the period of 2003-2007.





Source: eSignal

can push rates to a certain point, but there is some sort of a ceiling there as long as the Fed keeps policy where it is. It wouldn't surprise me to see [yields] come down."

With really only one direction to go, most analysts expect bonds to continue to drop and yields to rise, but in a slower fashion and not without corrections. Wilkinson sets the range for 10-year yields anywhere 50 basis points away from the 2.5% yield in the aftermath of the June FOMC meeting. "I could see both sides touched before the end of the year," he says. "The biggest threat to the bond market is if it turns out like the Fed expects, which is tepid growth that requires less intervention from the Fed but with low inflation. Once the bond market gets its head around that, yields will soften and remain below 2.5% in the 10-year."

Bruce Mumford, director at 2100 Xenon, expects rates to continue higher the rest of the year. Xenon, a commodity trading advisor that successfully caught the move in bonds, expected the steepening yield curve. "We put on a steepener across the globe," Mumford says. "You are going to continue to see a creep up in rates, there may be a retracement, but unless the world falls into the soup, [rates will rise]."

Will stocks give a damn?

If equities managed to rally to all-time highs during a weak recovery with high unemployment, does that mean they will fall once the news turns good? Some analysts believe this, some don't and there is no consensus on where the economy is headed.

Although Wilkinson and others agree with the spoiled child analogy, Bush says QE3 was more directly tied to the performance of equities. "The areas that look better are the ones that are most susceptible to quantitative easing, like housing or even autos, yet manufacturing has not done well. The velocity of money is very weak," he says. "The stock market could drop on better economic news. The good news could be bearish and the bad news could be bearish, either way the Fed is going to scale back."

Bush also sees more practical reasons to be bearish. "Earnings are not going to be good this quarter, there have been a large number of pre-announcements that were negative vs. positive for [the] second quarter," he says. "I am looking for lower equities, weaker than anticipated earnings [and] higher interest rates."

Lavender also is skeptical of market strength. "The rapid rise in the Dow has everybody spooked. From 15,000 a 10% correction would be 13,500, and that is nothing," he says. "And yet a 10% pullback is a big deal, and I could see that happening in one day. I don't think the economic numbers justify where the market is."

Buckley agrees, but expects any selloff to be short-term. "Out of the firms that have pre-reported Q2 earnings, 70% have negative guidance," he says. He also points out that the final first quarter GDP number, 1.8%, was dramatically lower than the previous estimate of 2.4%.

Despite these headwinds, Buckley expects the S&P 500 to get back to the 1700 level by the end of the year but not without volatility. "[Equities will be] choppy throughout the summer and will get the typical back to school [rally] in September. But October is typically the most volatile month. We will get back to 1700, but it is not going to be a pretty trip."

He also is concerned with numerous geopolitical events that could spark a huge sell-off.

Wilkinson, however, is more positive. "I have never known a bear market to start with strengthening economic data. They are struggling with that notion right now. But all said and done, economic growth does pick up and that feeds corporate earnings, that feeds business confidence, and I project the equity market continues its path to new

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highs throughout 2013," he says, adding, "What we are going through right now is all short-term noise. I would not be surprised if there was a new all-time high in the S&P 500 before the end of 2013."

While some traders argue the fundamentals, others like to look for patterns, and Frederick see a pretty clear pattern to the current equity bull market that began in March 2009.

"Historical patterns will tell you that we should have had about an 8%-11% return this year, and we are up more than that," Frederick says. "We are slightly ahead of target, but you also have this external influence of the Fed that hasn't always been in bull markets of the past."

Frederick says the current bull equity market is eerily similar to the one from 2003-07. "If you map the current S&P 500 pattern from January 2009 to present and you map that on top of January 2003 through the end of 2007, the two lines are scarily similar, they are so close to how and when they went up (see "Repeating patterns," page 22).

Frederick says this pattern indicates an 8%-11% gain for the year in the S&P, but adds "With the Fed intervention you have to add a couple of percent because we know the Fed is going to be involved at least until the end of the year. I see the market in the worst case scenario being pretty close to where it is right now, but the greater likelihood is that it will be a little higher."

The obvious question is if the current bull market is mirroring the 2003-07 bull, will 2014 look like 2008? "I don't think so because you have to look at what was going on at the time," Frederick says. "We had the housing market bubble, we had all sorts of mortgage related derivatives that were being grossly overvalued in terms of their credit quality; we don't have those sorts of things going on now, we have a much more realistic economy."

For all the talk of Fed interventions and whether good news will be good news and bad news will be bad news, the real question that splits bears and bulls is whether the economic outlook actually is strong or not. Is there really a recovery, or was it all just the product of the Fed and what will happen when the training wheels come off? This was the question we posed back in March, and now that the Fed has committed to taking the training wheels off, many are scared.

"The market will figure out what a less active Fed looks like by the time they start to make changes in their bond buying program," Frederick says, "The consensus is that it will be the September meeting. My recommendation is to be very cautions right now because I don't know if the pullback is over."

As to the relationship between bonds and equities, the June unemployment situation report released on July 5 showed better than expected growth in non-farm payrolls: Bond prices tanked and the S&P 500 held a strong rally. Welcome back to normal. Can we even recognize it? F

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