<u>THE EASYGOING FED: SWEET TALKING AND STOCKS</u>

(c) Leo Haviland, 646-295-8385 June 20, 2013

"Look out, look out, the Candyman
Here he comes and he's gone again
Pretty lady ain't got no friend
Till the Candyman comes around again…" "Candyman", a Grateful Dead song

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CONCLUSION

The S+P 500 trend and level are important variables in Federal Reserve Board decision-making. Recent statements by the Fed hint that for the near term this revered marketplace monitor probably is relatively (increasingly) unwilling to incite rallies beyond the May 2013's 1687 height., At around the 1475 to 1520 range, the Fed might offer some attention-capturing and enticing aid- even if it is only sweet talk emphasizing its commitment to its beautiful long-lasting easy money regime. The easygoing Fed probably will volunteer notable support to the S+P 500 around 1350, though it nevertheless may await the 1265 to 1315 span before it offers dramatic marketplace help.

EASY RIDER

"Come on boys and wager, if you've got the mind,
If you've got a dollar, boys, lay it on the line,
Hand me my old guitar
Pass the whiskey round,
Won't you tell everybody you meet that the Candyman's in town." "Candyman"

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To escape from the agonizing darkness of the worldwide economic crisis, to spark, propel, and sustain a joyous recovery, the friendly Federal Reserve Board has engaged ardently in highly accommodating actions and talk.

What has this aroused and watchful sentinel unveiled in its dances on the interest rate and monetary stage? As the dreadful disaster accelerated, the Fed vigorously slashed interest rates. From December 2008 up to the present, the ever-vigilant Fed has pinned the Federal Funds rate beneath .25 percent (monthly average). Compare October 2007's roughly 4.75pc, the month of the 10/11/07 pinnacle at 1576.

The easygoing Fed's interest rate manipulation (yield repression) and other financial maneuvers stretch further. Recall their assorted massive money printing (quantitative easing) escapades.

The adventurous QE buying program not only swallowed United States Treasury and other debt securities (such as mortgage-backed instruments), but also thereby helped to push down US government and corporate yields. Bond owners and corporate borrowers rejoiced at rate declines. Sovereign, Wall Street, and Main Street debtors happily embraced lower rates! American stock marketplace "investors" and other equity bulls have applauded ecstatically the gigantic rally in the S+P 500 since 3/6/09's 667 major trough.

When has the Fed engaged in heated QE entrances? Although it generally has not disgorged its beloved hoard of debt securities purchases, it at times has quit a QE procedure. In November 2008 and March 2009, the fervent Fed announced QE1. However, the charming guardian eventually left town, ending QE1 in March 2010. However, it graciously reentered the money printing game, unleashing QE2 in end August/November 2010. Satisfied with its actions, the central bank quit QE2 in June 2011. However, in the intermission, don't overlook the Operation Twist parlor game announced 9/21/11. On 9/13/12, the Fed rolled out QE3. It supplemented this money printing with QE4 (or QE3 plus) on 12/12/12, generously offering additional policy guidance on interest rates (inflation) and unemployment and renewing its oath of maintaining sufficient accommodation.

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The Fed's slick accommodative policies and honeyed wordplay involve an effort to restore household net worth and encourage consumer spending. They also aim to boost prices in the equity marketplace (use the S+P 500 as a signpost) as well as the real estate playground.

Study the Fed's "Flow of Funds" ledger (Z.1, Table B.100.e, including "Historical Annuals" 6/6/13 release). At end 2007, the balance sheet of US households (and nonprofit organizations, combined) stood at about $66.9 trillion, of which "equity shares at market value" were $20.9tr. At end 2008, net worth had tumbled to $54.2tr (down 19.0 percent), with equity shares valued at just under $12.5tr (a 40.2pc dive).

The S+P 500 touched bottom on 3/6/09 at 667. Though it has had various twists and turns, the S+P 500 has mounted for over four years, reaching to a record high at 1687 on 5/22/13. By end calendar 2012, consumer net worth had climbed to about $67.3tr, with equity marketplace shares valued at $20.6tr. By end 1Q13, households (and nonprofits) net worth was $70.3tr, including stock at about $22.5tr. Thus end 1Q13 household net worth even exceeded end 2007's by about 5.1 percent, with stocks up 9.6pc. Versus end 2008's gloomy valley, 1Q13 net worth ecstatically soared about 29.7pc, with stocks flying about eighty percent higher. Although these Z.1 statistics are nominal (do not adjust for inflation), the Fed surely congratulates itself for this dramatic ascent in household net worth and the related leap in equity prices.

The Fed has been married to its accommodative policies for several years. Its promise to remain devoted to virtuous easing principles for an extended period reappears in vows after FOMC meetings as well as in its inspiring speeches and diligent Congressional testimony. In its 6/19/13 FOMC rendezvous, the Fed heralded it would continue to pursue its lax monetary policies ("Press Release").

However, the Fed nevertheless recently murmurs that it may not remain forever as accommodating. Perhaps it will reduce in the relatively near future the rate at which it now buys UST and mortgage-backed securities. After all, it did quit QE1 and QE2. Moreover, the Fed resumed its pillow talk of its beloved exit strategies lately. Various Wall Street walkers and economic guides eagerly watch and listen for warning signs and actions by the Fed indicating reduced easing. These include a slowdown or elimination of its current generous money printing program.

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Over the misty horizon of the long run, assuming nominal US GDP keeps climbing, the Fed will tolerate and perhaps encourage a continued upward drift in the S+P 500. After all, the Fed desires and has wedded itself to a long run inflation target of around two percent.

Yet is the current party in the S+P 500 finished or at least fairly close to ending? Probably. In recent weeks, the Fed has hinted about possible revisions to its exit strategies. Though it has not warned of “irrational exuberance”, it has worried that some marketplace searches for yield (return) could be excessive. This suggests the Fed probably at present is not inclined to push the S+P 500 much beyond its recent high neighboring 1700. Of course the Fed surveys other economic variables, not just stocks. Equity prices gyrate due to corporate profits and other factors, not just Fed views and behavior. And the Fed obviously is not the only major central bank engaged in long running easy money strategies.

Sustained relatively lofty equity prices are crucial to the achievement of the Fed’s entwined goals of economic recovery and a stronger consumer balance sheet(and thereby growing consumer spending; after all, consumers represent the lion’s share of GDP). Moreover, recall the Fed’s track record of easing after significant dips in US equity prices. The Fed does not want the S+P 500 to fall out of bed. So at what S+P 500 locations might the Fed intervene with renewed accommodative rhetoric and perhaps inspiring actions? Fed preaching and Fed behavior do not mandate halts in bear moves.

Assume that at or around 5/22/13’s 1687 summit or a level close to it is an important high (Dow Jones Industrial Average high 5/22/13 at 15542). A five percent drop in the S+P 500 produces 1603, with a 10pc slump 1518 (close to the 9/14/12 top at 1475; the average of the 2/16/13 and 4/18/13 rally take-off points, 1485 and 1536, gives about 1511). Twenty percent erosion winds the price down to 1350, with a 33pc swoon about 1125.

Focus on some of the Federal Reserve Board’s economic rescue measures in recent years in the context of S+P 500 dives.

If the S+P 500 creeps five percent lower, that quite probably will worry the Fed little if at all. However, this economic doorman probably will offer sugarcoated wordplay, and maybe some renewed easing (most likely some incremental money printing), if the S+P 500 falls 10pc. First, note the emergence of talk of easing after the S+P 500 fell from 4/2/12’s 1422 to its 1267 bottom on 6/4/12, a 10.9pc decline. Admittedly the Fed did not uncover QE3 until mid-September 2012, with the S+P price around 1475. The Fed very likely was severely disappointed by the wilting of the S+P 500 from 1475 despite its glorious proclamation of QE3. However, the Fed, after the S+P 500 fell a modest 8.9pc down to 1343 on 11/16/12, not long afterwards opened its easing door more widely with its 12/12/12 policy guidance on inflation and unemployment and a further boost in money printing.

What about a twenty percent S+P 500 fall? Recall the 4/26/10 high around 1220. The Fed ended QE1 in March 2010. This benchmark index reached its bottom on 7/1/10 at 1011, a fall of 17.1 percent; it made a second low at 1040 on 8/27/10. Highlight the gradual appearance on the runway from end August to November 2010 of QE2’s money printing. On 5/2/11, the S+P 500 established a noteworthy interim peak at 1371. QE2 ended in June 2011, alongside this marketplace top. Equity bulls bemoaned the bloody crash in the S+P 500 to 10/4/11’s 1075. As the price fell off the table, and not long before the October low, the Fed ushered in Operation Twist (9/21/11). The rapid deterioration from the May 2011 plateau to the October low was 21.6pc. Since these two falls of around twenty percent apparently helped to prompt Fed action, a twenty percent stumble from any notable pinnacle probably would arouse Fed easing activity. In addition, many marketplace clairvoyants promote the opinion that a twenty percent marketplace plunge defines a bear marketplace. Consequently, the Fed does not want bearish sentiment to accelerate declines in the S+P 500 and thus dampen enthusiasm in the so-called real (wider) economy.

Another consideration argues for notable Fed talk or action if there were a 20pc nosedive in the S+P 500, especially one from at or around the recent high at 1687. The Fed arguably has the rapid S+P 500 collapse in 2008 from interim tops around 1300 in mind (highs of 8/11/08 at 1313 and 9/19/08 at 1265; these followed not only the 10/11/07 top, but also 5/19/08 interim summit at 1440). Note the proximity of 1350 (a 20pc fall from 1687; see as well 11/16/12's 1343) to the 1313/1265 range. The 10/11/07 major high at 1576 (close to the 3/24/00 major top at 1553) down to 1300 represented a 17.5pc decline, with a trip down to 1265 about 19.7pc. Incidentally, in regard to the 9/19/08 high at 1265, recall the 1267 low on 6/4/12, and that rumblings of a new version of Fed QE began around that time (though QE3 actually arrived 9/14/12).

A drop greater than 20pc of course increases the odds of more Fed easing.

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Upcoming Fed meetings are 7/30-31/13, 9/17-18/13, and 10/29-30/13.

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Chairman Bernanke may leave the Fed when or shortly before his second four year term ends in January 2014 (NYTimes, 6/19/13, ppB1-2).

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Shine a light on another crucial marketplace for a moment, the US Treasury one. Keep in mind the 7/25/12 major low in the UST 10 year at about 1.38pc and the rather steady yield advances since then. In recent years, Fed easing and other factors (including flight to quality fears) have wooed many foreigners to buy and hold UST securities. However, in April 2013, UST notes and bonds suffered foreign net selling of about $54.5 billion. The foreign official sector unloaded about $23.7bb (with the international and regional category selling another $3.4bb). Other foreigners (the private sector) also departed town in April; they were net sellers of about $27.4bb. These Treasury statistics run back to 1978. Although there is much more UST debt around nowadays than in the distant past, this $54.5bb total not only is the biggest net sale by the foreign sector in history in any given calendar month, but it also stands out within the past few years.

Foreigners indeed still grasp an enormous amount of UST securities. But what happens to UST yields- and to the S+P 500- if foreign net selling of UST sustains these April 2013 levels in coming months? Assuming no dramatic sustained improvement in the US federal deficit, and supposing that agitated overseas UST holders continue to exit around such rates, how easy will it be for others (including the Fed) to absorb such net overseas selling of Treasuries?

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