Fed Yanking Punch Bowl

***e*Research Corporation** is pleased to provide a weekly commentary, authored by Tom McClellan, entitled "The McClellan Chart-In-Focus", which is a free technical analysis article published each week.

In this article, Mr. McClellan looks at why he believes the Fed is responsible for the market turbulence, which he thinks is likely to continue.

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Bob Weir, CFA
Director of Research

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The McClellan Chart-In-Focus

by Tom McClellan (bio at end)

It Is The Fed, Yanking The Punchbowl

We were having a perfectly nice low-volatility uptrend until January 26, and everyone was happy. Since then, the inverse VIX ETN, known as XIV, has blown up (a great case of a "burning LOH" marker), and traders are starting to remember that stock prices actually can go down. So, why now?

As with most bear markets and recessions, the blame goes to the Federal Reserve, which decided last year that it would start unwinding all of the QE buying of T-Bonds and Mortgage Backed Securities (MBS) that it had bought up from 2009-14.

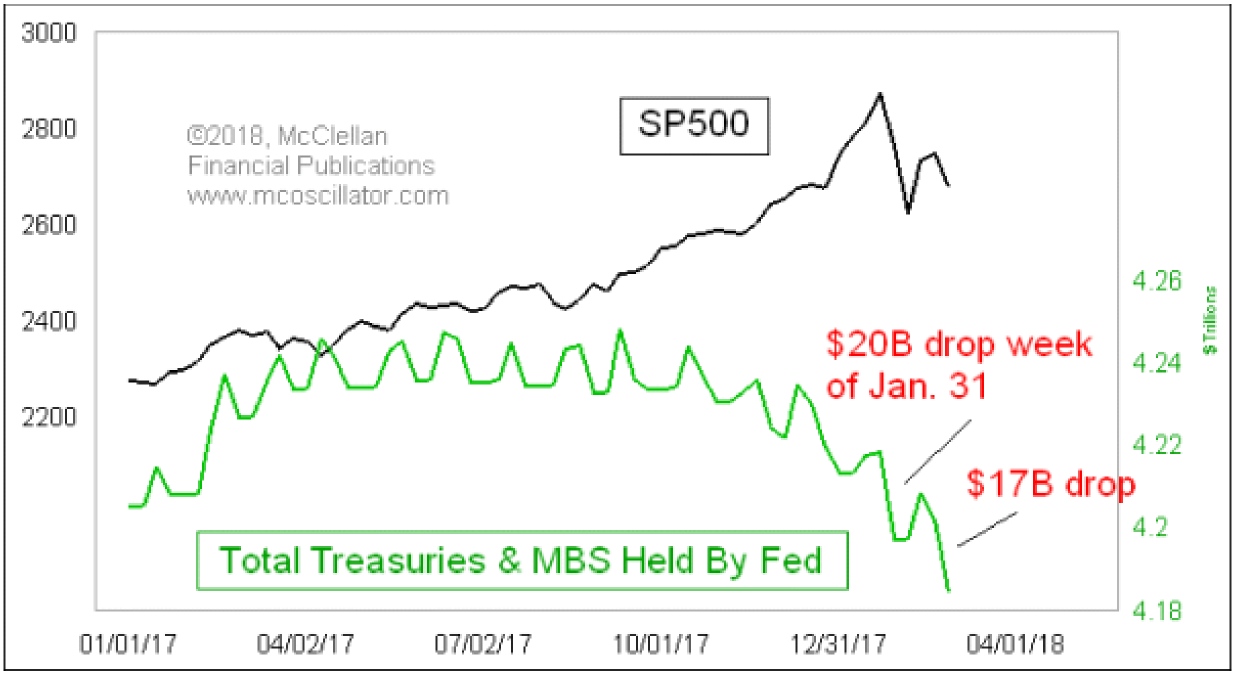
Last year, the Federal Reserve under Janet Yellen announced plans to start liquidating those bond and MBS holdings, starting at a rate of $10 billion per month in Q4 of 2017, and ramping up that rate by an additional $10 billion in every quarter to follow. So the target rate of sales for Q1 2018 is $20 billion per month, and it is supposed to ramp up to $30 billion per month in Q2, then $40 billion per month in Q3, eventually peaking at a $50 billion per month rate in Q4 and beyond.

Selling bonds into the open market means that the banking system has to give up "money" to pay the Fed for the bonds and MBS that the Fed is selling. I am not going to get into a discussion about the various definitions of "money", and how it is all just a ledger exercise. But, it is clear that the selling of bonds by the Fed reduces the amount of liquidity in the banking system, which has effects on the ability of stock prices to remain at lofty levels. And it probably does not help to have the Treasury Department doing its own bond sales at a higher rate.

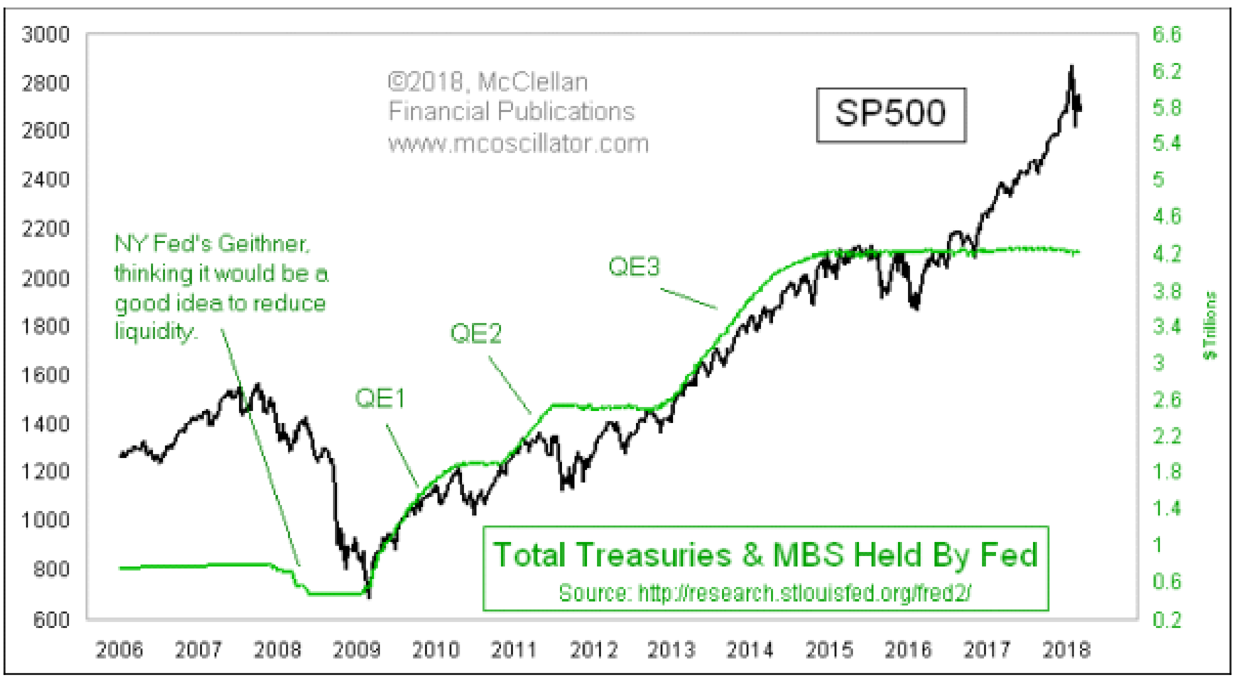
The stock market is not taking this well, which should not be a surprise. Part of the market's indigestion may come from the lumpy way that the Fed's balance sheet is changing. It is not a smooth, gentle glide path, but rather a saw-tooth pattern, which tends to introduce turbulence into the banking system. That turbulence flows through into stock prices, as we are seeing.

These amounts might seem like they should be inconsequential, especially for a stock market which trades $100-200 billion of stock every day.

However, as the first chart shows, the Fed's actions do seem to matter, and the drops in the Fed's balance sheet are coinciding with the big weekly drops for stock prices.



Even at this higher rate of bond sales, the Fed still has a long way to go to unwind its balance sheet, which at its peak stood at $4.25 trillion worth of T-Bonds and MBS. In this next chart, one can barely even detect the reductions which have taken place thus far:



But we can see how stimulative to stock prices it was to have had QE1, 2, and 3. Each time those were just stopped, the market ran into an illiquidity problem. The May 2010 Flash Crash followed the cessation of QE1. When QE2 was stopped in June 2011, we got a 19% decline in July 2011.

The Fed ended QE3 more slowly, "tapering" the size of its bond and MBS purchases very gradually before ending them completely in late 2014, but we still got the China minicrash in August 2015, and an aftershock in January 2016. Those events all arose not from any actual unwinding of bond holdings, but just from stopping the buying.

It is illustrative to look back to 2007-2008, when the Fed actually did a series of T-Bond sales. Under the leadership of the then-president of the New York Fed, Timothy Geithner, the Fed reduced its holdings of T-Bonds from a high of $791 billion in August 2007 to a low of $475 billion in March 2009. It is a bit of a mystery exactly why the Fed thought it was a good idea to sell bonds and take money out of the banking system during the worst liquidity crisis in decades. But that 2007-2009 bear market did help secure the election of President Obama, who then appointed NY Fed President Geithner as his Treasury Secretary, so you can insert your own conspiracy theory here.

My expectation for 2018 is that the officials at the Federal Reserve are eventually going to realize that their proposed accelerating rate of bond sales is having an adverse effect, and they will alter their course. But they are not going to realize that for a while and, so, stock investors are in for a much wilder ride in 2018 than what they have become accustomed to.

Tom McClellan, Editor,

The McClellan Market Report

BW: Information on Tom McClellan and *The McClellan Market Report* and *The Daily Edition* follows on the next page.

ABOUT THE AUTHOR

Tom McClellan

Tom McClellan has done extensive analytical spreadsheet development for the stock and commodities markets, including the synthesizing of the four-year Presidential Cycle Pattern. He has fine-tuned the rules for inter-relationships between financial markets to provide leading indications for important market and economic data.

Tom is a graduate of the U.S. Military Academy at West Point, where he studied aerospace engineering, and he served as an Army helicopter pilot for 11 years. He began his own study of market technical analysis while still in the Army, and discovered ways to expand the use of certain indicators to forecast future market turning points.

Tom views the movements of prices in the financial market through the eyes of an engineer, which allows him to focus on what the data really say rather than interpreting events according to the same "conventional wisdom" used by other analysts.

In 1993, he left the Army to join his father in pursuing a new career doing this type of analysis. Tom and his Father spent the next two years refining their analysis techniques and laying groundwork.

In April 1995 they launched their newsletter, The McClellan Market Report, an 8-page report covering the stock, bond, and gold markets, which is published twice a month. They utilize the unique indicators they have developed to present their view of the market's structure as well as their forecasts for future trend direction and the timing of turning points.

A Daily Edition was added in February 1998 to give subscribers daily updates on their indicators and also provide market position indications for stocks, bonds, and gold. Their subscribers range from individual investors to professional fund managers. Tom serves as editor of both publications, and runs the newsletter business from its location in Lakewood, WA.

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