The Fed's Price Keeping Operation

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The US equity market is a constant source of surprise, but what really amazes me is any suggestion that it is "trying to tell us something". Between algorithms, indexation, closet indexation, regulations, exchange traded funds, structured products, trackers, negative interest rates and of course massive central bank intervention, "Mr. Market" probably has very little to say, save that he is hopelessly lost. Put another way, the notion of the market being a forum for "price discovery" seems like a shibboleth from another era, at least during the last five years.

The only discovery process which now seems to matter is the likely action of the central bank(s) this week or next. The rest is just conversation. Indeed, it is moot whether this strange new creature can credibly even be called "a market". At best it is a policy tool to be manipulated, just like interest rates or the exchange rate. And, of course, the only price which matters is that which the central bank deems to be the right one.

The stock market has become like any other economic variable which can be manipulated

To illustrate the point, consider the chart overleaf which shows a configuration that I have never seen in 40 years of studying markets. Three times in the last fifteen months the S&P 500 started to run out of steam with the subsequent descent being precipitous as it quickly hit oversold territory. The impression was of a big buyer taking a rest.

As a result, the stock market started to look decidedly "sick". Yet on all three occasions when the S&P 500 fell below the 1870 level, it not only rebounded, but powered higher to a point that it was as overbought as it had been oversold just a few weeks previously. Moving from oversold to overbought in a few weeks is pretty uncommon; doing it three times in a row, in just 15 months, to my knowledge has not happened before.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US existing home sales fell –7.1% MoM to 5.1mn in Feb, from 5.5mn in Jan	Worse than 5.3 mn expected	Expect US home sales to stay supported given low mortgage rates
Eurozone current account surplus fell to €25.4bn in Jan, from €28.6bn in Dec	N/A; 3% of GDP; exports fell more than imports; primary income surplus also narrowed	German consumption & investment cycle picking up; if sustained surplus will fall further
Eurozone consumer confidence fell to –9.7 in Mar, from –8.8 in Feb	Below –8.3 expected; third consecutive monthly fall	Indicator for GDP growth trend; can ECB's QE & TLTRO extension lift slowing growth trend?
India current account deficit narrowed to $7.1bn in 4Q, from US$8.7bn in 3Q	Below –US$3bn exp; at 1.3% of GDP, financing of CA deficit not a significant headwind	Healthy external position provides a favorable backdrop for capex revival

The market has bounced back from oversold to overbought territory three times in 15 months...

Three strikes and you are out?

Overbought market: RSI (35) above 64; oversold market: RSI (35) below 33

Gavekal Data/Macrobond

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The implication is that someone or something has decided that the S&P 500 is not authorized to fall below the 1900 level and, hence, that entity needs to be tested as to the strength of its hand. Alternatively, it could just be that silly algorithms continue to make a mockery of markets, in which case the best thing would be for the authorities to simply close down the light-speed trading desks. Or there is perhaps a third explanation:

Consider the notion that in our new world of high level "price keeping operations", Wall-Street equity prices have two components; namely a "fair" value around which shares should trade if this were a "normal" world, and also a "premium" above that fair value level, which reflects investors confidence in the central bank's ability to stop equities falling.

The worry must be that, if at some point, the belief coalesces that the Federal Reserve's "put" is no longer working, then a crash may follow in short order, just as in 1987 when investors realized that much hyped portfolio insurance was bogus. And this is perhaps why the last 15 months has (likely) seen the arrangement of three PKOs.

...however the ultimate effectiveness of price keeping operations has never had a happy ending

The bad news is that I cannot identify one case in 4000 years of economic history when any entity has been able to stabilize a price, any price. And I find the current attempt by central bankers to achieve such a result about as promising as King Canute's effort to turn back the waves. Of course Canute was making the point to his courtiers that there were limits to his magisterial powers. There seems to be no such self awareness in the corridors of power within our central banks.