

Stocks Dive as Confidence in Fed Fades

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“Investors are losing confidence in central bank policies. (They) have done all they can do, and these policies may not improve economic growth or may not support financial markets.”

— Anthony Valeri, investment strategist at LPL Financial

Zero rates and QE have stopped working and that has investors worried. Very worried.

If you want to know why stocks have been taking it on the chin lately, look no further than the quote above. Mr. Valeri nails it. The Central Banks have lost their touch which is why investors are cashing in and heading for the exits. This has nothing to do with the slowdown in China, bank troubles in Europe, capital flight in the emerging markets, droopy oil prices, or the deceleration in the global economy. Forget about that stuff. The real problem is that investors have lost confidence in the Fed. And for good reason.

Keep in mind, that for the last 5 years or so, bad news has been good news and good news has been bad news. What does that mean?

It means that every report that showed the economy was underperforming or getting worse was greeted with cheers from Wall Street because they knew the Fed would promise additional accommodation (QE) or continue to maintain zero rates into the future. The Fed conditioned investors to ignore fundamentals and merely respond to the Pavlovian promise of more cheap money. That cheap money helped fuel a rally that tripled the value of the S&P 500 while inflating asset bubbles across the spectrum. But now the impact of low rates appears to be wearing thin which has investors concerned that the Fed has run out of bullets.

Why? What changed?

In the last couple of weeks, the second and third biggest central banks (The European Central Bank and the Bank of Japan) either announced or launched additional easing programs, but to no effect. The BOJ implemented negative rates (NIRP) expecting the yen to weaken and stocks to rally. Instead, stocks fell off a cliff losing an astonishing 7.6 percent on the Nikkei while the yen strengthened by nearly 10 percent against the dollar. In other words, the results were the opposite of what the BOJ wanted.

The same thing happened to the ECB although Mario Draghi has not actually increased QE yet. The ECB is currently buying €60 billion of mainly sovereign bonds per month under the existing program ostensibly to trigger credit growth and boost inflation. Draghi increased speculation that he would boost the bank's monthly purchases (by €15) at the World Economic Forum in January when he said:

“We have plenty of instruments. We have the determination, and the willingness of the governing council to act and deploy these instruments.”

Usually, a strong statement like that would be enough to send stocks into the stratosphere, but not this time. Since then, EU markets have tanked and the euro has strengthened against the dollar. Once again, the results have been the exact opposite of what was intended.

So the question is: If the promise of easy money and QE is no longer working in Japan or Europe, why would work in the US? Or, put differently: Has radical monetary policy lost its ability to prevent stocks from going into freefall? (The Bernanke Put)

This is what investors want to know.

Keep in mind, QE has not increased inflation in any of the countries where it's been implemented. Nor has it boosted lending, triggered a credit expansion or strengthened growth. It's a total fraud. But it has had a big impact on stock prices, which is why central banks love it.

But now that's changed. Now QE is backfiring and zero rates have lost their potency. Investors know this. They know that monetary policy has run-out-the-clock and that overpriced stocks –which have been outpacing flagging earnings for years–are going to return earth with a thud. This is why the selloff could continue for some time to come.

Of course, now the focus has shifted to “negative interest rates”, the latest fad in central banking that is supposed to boost lending by charging banks a small fee on excess reserves. It's another nutty attempt to prove that if you put money on sale, people will borrow. But what we've seen over the last seven years is that there are times when people won't borrow no matter how cheap money is. The Fed can't seem to grasp this. They can't see to wrap their minds around the simple fact that reducing the cost of borrowing, does not always make it more desirable. Households that are trying to pay down their debts, increase their equity or save for retirement might not want to borrow regardless of how cheap the rates might be.

In any event, negative rates (NIRP) have already been implemented in Europe and Japan where the results are mixed. Here's how Nomura's chief economist Richard Koo summed up the phenom in his recent newsletter:

“In my view, the adoption of negative interest rates is an act of desperation born out of despair over the inability of quantitative easing and inflation targeting to produce the desired results. That monetary policy has come this far is a clear indication that both ECB President Mario Draghi and BOJ Governor Haruhiko Kuroda have fundamentally misunderstood the ongoing recession.....” (“Macro and Credit...The Vasa Ship”, [Macronomics](#))

Indeed. Now compare Koo's comments to those of OECD Economic Committee Chairman, William White, who was asked what he thought the effects of negative rates would be on the economy in a recent Bloomberg interview:

William White:

“The truth is, nobody really knows. The thing about these experiments, is that they’re experiments. We have no historic precedence for this kind of behavior by central banks at all. EVER. So the answer is: We don’t know. The general idea is that if you charge negative interest rates on the reserves that the banks hold at the central banks that somehow this will translate into lower lending rate and more stimulus for the economy. But you have to realize that these negative rates will actually squeeze the banks margins, squeezing bank profits. This is something we actually don’t want because we want them to make more money so they can build up capital buffers. So what are the banks going to do?”

Well, one possibility is that they lower the deposit rates for customers. That’s possible, but then people might take money out. The other possibility is that you simply raise the rate for people to borrow, which is the exact opposite for which the policy was intended. So, I repeat, this is all experimental. We’ll wait and see how it turns out. But I’m rather skeptical.”

(“[OECD’s White Says More Wage Growth Attention Needed](#)”, Bloomberg)

In other words, it’s just not a very well thought-out plan. Either the banks take the hit or the borrowers do. Either way, the plan won’t boost lending, generate a strong credit expansion or grow the economy. After seven years of this same nonsense, we should be willing to admit that reducing the price of money will not lead to an economic recovery. Of that, we can be 100 percent certain.

So, what will generate a strong recovery? This is the question Bloomberg put to White after he expressed his reservations about negative rates. Here’s his advice:

“Those who have fiscal room to maneuver, should use it.

I think there should be more attention paid to wage growth, which has been too low and so spending has been too low in consequence.

We need much more public infrastructure which is an asset to go with a government liability.

We need more systematic approaches to debt reduction and debt relief.

And we need a lot more structural reform to get that low hanging fruit to allow the economy to grow faster and to allow debt service to be more easily managed.” (“[OECD’s White Says More Wage Growth Attention Needed](#)”, Bloomberg)

Fiscal stimulus? Wage growth? Debt relief? Progressive reforms?

In other words, we’ve piddled-away seven-long years on radical monetary experiments that have achieved nothing and led us right back to where we began, at plain-old Keynesian fiscal stimulus, the only reliable way to put people back to work, stimulate growth, and get the economy back up-and-running.

Better late than never, I guess.

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