Are we heading for a Bear Market?

October 13th, 2014

Dear Clients and Friends,

As you are likely aware, the equity markets have seen a significant increase in volatility over the past week. In fact, the DOW Jones Industrial average crossed into negative territory today with the S&P 500 and Nasdaq still showing minimal gains on the year.

BIG QUESTION: Are we now entering the next bear market?

I don't think so. At least --- not yet. I offer the following thoughts in support of this view:

David Zervos, Chief Economist at Jefferies, has been writing lately about the potential for greater volatility given that the Fed now has to communicate monetary policy in a different environment --- an improving economy. We all know that short term interest rates traditionally move higher with an improving economy. Accordingly, the market is far less certain about where short term interest rates will be in 12 months than it was a year ago --- when it was convinced the economy still "needed" low interest rates.

It is clear that the U.S. economy is healing --- which means an eventual rise in interest rates. As the Fed tries to raise rates while at the same time convincing market participants that it won't kill the economy --- it understandably creates confusion. I believe this confusion is driving the market's decline. That said, the dominant theme to focus on here is that the U.S. economy IS healing. The business cycle IS improving. Consequently, the market's decline is likely to be transitional in nature.

Bottom line: I do NOT believe we are on the verge of the next BIG correction. In my opinion, the next BIG correction is likely to materialize when the narrative of "Central Bank Omnipotence" unravels.

Ben Hunt, writer of the Epsilon Theory blog, has been writing extensively about this Narrative of "Central Bank Omnipotence". He seeks to synthesize the theories of behavioral finance and game theory into practical advice for the market's direction and movements. Essentially, he believes that "as long as the world believes that the Federal Reserve IS omnipotent --- then it doesn't really matter whether they are or not." That is because market participants act on what they "believe", not on

fundamental reality. If the market ever begins to doubt that the Fed can and will rescue the economy ---- that would spell disaster for financial markets.
In his latest article, he contends that the "real news" of late is the change in the market's reaction to European Central Bank policy as communicated by Mario Draghi. (Europe's version of Bernanke/Yellen.) The following is a quote from his note last Wednesday after the market rebounded from Tuesday's sell-off:

> *What's interesting to me is not this latest success of the Narrative of Fed Omnipotence.* ***No, what's interesting to me is this week's failure of the Narrative of ECB Omnipotence.*** *The Fed minutes totally bailed the market out today and (truly) revealed the Fed as the only central bank with the Common Knowledge firepower to withstand a serious growth scare. The ECB, on the other hand, has lost an enormous amount of Narrative mojo over the past week. The perception of Mario Draghi has clearly shifted from Super-Mario, willing and able to do "whatever it takes", to what we would call in Texas "all hat and no cattle".*

If Ben Hunt is right ---- the perception of the Fed's Omnipotence now matters more than ever. I agree with Ben Hunt, which is also why I don't believe we are on the edge of the next bear market. Market participants may be frustrated with the Fed's communication policy as the economy is transitioning --- but there is still a very strong belief by "the market" that the Fed IS in control. In spite of the current volatility, I believe the Fed will figure out a way to communicate effectively that it can navigate this transition of the economic cycle. In my opinion, market prices should test their highs again.

However, I also believe that the Fed is fundamentally NOT in control --- a reality which doesn't appear to matter at the moment. It will matter someday. When it does --- risk assets everywhere will suffer substantial losses. Accordingly, I believe it is prudent to continue trying to extract some profit from this aging bull market --- while also planning for the eventual new narrative --- one that distrusts the Federal Reserve's control over the world economy.

Bottom line: If the market can turn against Mario Draghi ---- it can also turn against Janet Yellen. Just not yet.

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