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Monetary Policy in Wonderland

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I continue to be struck these days by investors' deranged acceptance of current monetary policy as the norm. Few are fearful of zero or negative interest rates' adverse ramifications and disruptive impacts.

As I put it yesterday:

"Two decades from now, we'll likely look back at 2000-2016 monetary policy with disbelief that investors swallowed and accepted it.

As my friend Mark J. Grant wrote on Monday, it's almost as if we all now reside inAlice In Wonderland:

'"The White Knight's walking backwards and the Red Queen's off her head." We ignore it mostly. What can we do about it anyway? We have absolutely no control over the antics of the central banks. In fact, a lot of investments are made just by trying to outthink what these people might do next. Move your rooks first.

"Take some more tea," the March Hare said to Alice, very earnestly.

"I've had nothing yet," Alice replied in an offended tone, "so I can't take more."'"

-- Doug's Daily Diary, Apple in Wonderland: What's Up with AAPL (and the Fed)?(April 27, 2016)

The aberrant and unsound have become justified and excused, while malinvestment has become a mainstay as markets reach for yield.

As an extreme example of this, consider China's recent insane commodities trading, which defies all explanation. There are numerous other distortions in the marketplace as well.

Non-thinking consensus and acceptance have become the norm these days. And as I noted yesterday, when combined with central banks' easy monetary policies (i.e., "money for nothing"), the crowd is beginning to resemble the Mad Hatter from Alice in Wonderland.

I opined yesterday that global equity markets have become severely distorted by central bankers gone wild, and that we'll someday look back at all of this in disbelief.

But while price distortions can continue for some time, markets always ultimately regress to a mean. I believe that in this cycle, the return to natural price discovery will be a painful process that will hit global markets and investors by surprise.

Business TV's "talking heads" can rationalize the irrational all that they want with terms like "price is truth," but the rubber band between stock prices and the real economy has been stretched beyond most investors' wildest imaginations. This is happening even as it grows more clear that monetary largesse is losing its effectiveness both in the United States and Japan.

Last night might have been something of a fulcrum point, as global markets took risk off. The Nikkei 225, the European markets and S&P 500 futures all fell overnight after the Bank of Japan held off on further monetary stimulus despite weak Japanese economic data and falling consumer prices.

Instead, the BOJ:

- Kept Japan's benchmark rate unchanged at -0.1%.
- Retained its current monetary base target, maintaining the same pace of asset purchases.
- Delayed the timing to reach the bank's 2% inflation target.

Most economists had expected little policy change from the Japanese central bank. But markets had been pricing in all sorts of "monetary goodies," from accelerated equity ETF purchases to a doubling of government-bond purchases to LTRO-style lending to banks.

In the absence of such moves, the Japanese yen rallied by the largest amount in five years against the euro and the biggest gains seen in roughly a year against the U.S. dollar.

The Bottom Line

"Guessing what governments do next at this moment in time is not a good way to play these markets. Hoping that there will be more stimulus will lead to disappointment, because hope isn't a very good strategy."

-- Andrew Clarke of Mirabaud Asia Ltd., talking to Bloomberg about the BOJ decision to stand pat (April 28, 2016)

The trend has long been your friend in this market, but you should stay alert for any inflection point and change of direction. Make no mistake about it, extreme monetary policy has inflated global equity prices; just look at how the Nikkei, Europe and the S&P 500 futures all fell after the BOJ disappointed markets.

If central banks ever normalize monetary policy and/or the currency train derails, expect all asset prices to lose their current moorings and retreat -- something that looks inevitable from my perch. To think that the powers that be can orchestrate tranquility when debt levels are where they are and economic growth isn't self-sustaining seems imprudent to me.

That's why it remains my view that May 2015 marked the start of a broad, important market-topping process -- and nothing that I've seen so far this year has altered that outlook. So, I remain very committed to the short side.

Position: Short SPY

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