THE FED SCREWED UP

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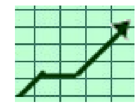

Stocks got crushed Friday, December 18th, the Industrials plunging 367 points after losing 253 points the day before. That's a loss of 620 points in two days for those of you keeping score at home. The S&P 500 got torched for 67 points the past two days, the NASDAQ 100 watched 150 points evaporate into thin air. All this damage happened after the Fed announced its first interest rate increase in 9 years.

It is bizarre that stocks rose sharply during the two day Fed FOMC meeting, a mysterious time-out inside a declining trend from our December 8th Purchasing Power Sell Signal, which resumed on Thursday, December 17th, and also was confirmed by our December 17th PPI Sell Signal. The S&P 500 lost 106 points after those two PPI Sell Signals. It's as if the market wanted to start a downtrend from the December high; however the Fed needed to paint the tape during their delivery of the bad news rising interest rate moment, as if the market was stupid enough to believe rising interest rates at this time are a good thing.

A cynic might think that the Fed, through its Plunge Protection Team authority, purposely pushed the stock market higher during the two day FOMC meeting, knowing it was going to increase interest rates and noting a declining stock market trend was developing, in order to assure market order and stave off a panic selloff on the announcement. If this is the case, markets returned to their downtrend Thursday, December 17th, recognizing economic trouble is brewing, and stock market prices are going lower. Certainly rising interest rates are not going to improve corporate earnings, or improve household income or net worth, nor add jobs to the economy. A free stock market sees this. The Fed raised interest rates in a slowing economy and in the face of commodities deflation. The decision was absurd. On Thursday and Friday, the stock market made this point.

It is interesting that the day after the Fed raised short-term interest rates for the first time in 9 years, and in the face of a slowing economy, U.S. Bonds rose, long-term interest rates fell. This is yield curve inversion action, which if it persists, is a warning of a coming recession. When I managed a $1.0 billion Bond portfolio, back in the day, one of the key indicators I paid attention to in order to time purchases was an inverted yield curve. It told me interest rates were topping, and the Fed was causing a recession. It was a great time to buy high quality Treasury and agency notes.

Anyone who believes that the stock market has risen after the Fed began a rising rate cycle in the past is not considering a few facts: First, the Fed has never before in its 102 year history (it has a birthday coming up on Wednesday, when a near vacant Congress rammed it into existence without a majority vote just before Christmas 1913) raised interest rates in the face of commodities deflation. Second, the Fed has only twice before raised interest rates in the face of a slowing economy. Wednesday was the third time it did this. The last two times it did this were a causal factor in the Great Depression of the 1930s and again in 1966 which was also a causal factor for the recession that followed. Since 1948, every Fed rate increase occurred with GDP growing faster than 4.5 percent. GDP is nowhere near that rate of growth now. Try 2.1 percent GDP growth at best, probably a lot worse if we take out GDP growth from illegal immigrant population increase, and consider strictly per capita U.S. citizen GDP growth. On December 8th, 1965, the Fed started a rising interest rate cycle in a slowing economy, which was promptly followed by a 26.5 percent stock market crash that started on February 9th, 1966, two months later. The ivory tower dopes continued to arrogantly raise interest rates six more times as the stock market plunged for six more months in 1966. The stock market was finishing a Jaws of Death pattern at the time the Fed started a new rate increase cycle, like it is now. It was a bad decision by the Fed then, and is a bad decision again now.

The point of raising short-term market interest rates is to slow an overheated economy, to cool inflation. The only place there is inflation right now is in necessities, not luxury products and services. This means the Fed could raise interest rates to 40 percent from 0.25 percent and it will not slow price increases for necessities. What prices are rising at this time? Try food, water, health care, health insurance, tuition. Necessities. Okay, and also the Fed's balance sheet if we want to get technical. Commodity prices are falling, including precious metals (many used in industry), oil, and gasoline, as are real estate prices outside of Manhattan and its surrounding communities (Manhattan and its surrounding territory benefited from the $5.0 trillion the Fed printed out of thin air the past several years and handed to Wall Street, while Main Street got nothing). There is no inflation to cool. Again, the Fed never before raised interest rates in the face of falling commodities. This is new turf, dangerous turf. It's a case of the old adage, the Fed marches into the battle after it's over and shoots the wounded. Talk about kicking the middle class and small business in the choppers.

If the Fed is focused on the need to raise interest rates because of all the Mergers and Acquisitions activity this year on Wall Street, that is nonsense because all this means for the economy is that large corporations are struggling to generate organic revenue growth, so are trying to buy it. That is a finance game, not economic growth. M&A also means layoffs, lots of layoffs. The fancy term we read about from the CEOs who discuss their Mergers is "synergies," code for layoffs, loss of jobs by middle income employees with families. The latest to hit the presses is the Dow Chemical / DuPont deal. There are a lot of nervous families this Christmas with bread winners who work in those two companies.

When we take a hard look at GDP growth, and at the employment data, Yellen argued the Fed's rate increase December 16th was necessary due to "substantial improvement in the labor market." Nonsense. She claimed in her Q & A that the economy had generated 2.3 million new jobs in 2015. Bullbleep. The Labor Department's own statistics from their CES Birth/Death report tell us that 804,000 of those 2.3 million supposed new jobs were a guess, an estimate, a melatonin dream from the bureaucratic bean counters, new jobs they think might have come from new positions they hope were created by the net of new businesses less the loss of jobs from businesses that went out of business. 804,000 jobs are a fictitious estimate. At best, the truth is, the economy created 1.5 million new jobs in 2015. Now, consider that the U.S. population grew by 2.2 million during 2015, and we see that new job creation never came close to keeping pace with population growth. Further, her mentioning improved employment as a reason to raise interest rates is bogus, just look at the labor participation rate. It is an abysmal 62.5 percent, down substantially from the turn of the century. The Labor Department counts jobs (supposedly), but we never get to see them report family supporting wage quality jobs, do we? If a minimum wage clerk job is created, it counts in the Labor Department's employment stats, and apparently the Fed is okay with that.

Let's look at some of the latest economic statistics as reported by the Commerce Department: The financial news networks made a big deal about New Residential Construction rising 10.5 percent in November, but what they did not mention was it fell 12.5 percent in October. Is that a sign of a robust economy? And, where are the sales going to come from? I don't know about you, but it is a miracle to see a Sold sign on a lawn in the mid-Atlantic to northeastern corridor of the U.S. where I have traveled this past year. Lots of For Sale signs, hardly any Sold signs. Commerce reported that New Residential Sales rose 10.7 percent in October, but they had fallen 12.9 percent in September. Is this cause to raise interest rates? I don't think so. After-tax profits for retail corporations were down in the latest reporting quarter for 2015. Commerce also reported that U.S. Total Business Sales fell 0.2 percent in October.

Getting back to a false sense of GDP growth that needs to be curtailed by rising interest rates at this time, again, since Truman was president, the Fed never raised interest rates when GDP was below 4.5 percent – until now. GDP was estimated by the Commerce Department to be 2.1 percent in the third quarter of 2015. Now, consider that some estimates have illegal immigrants entering the U.S. at around 500,000 per year, these unaccounted for folks are spending money, earning wages, in essence contributing to GDP growth statistics, which skews the GDP growth figures to be better than the GDP figure really is on a per capita basis for U.S. citizens, which is what really matters after all. In other words, between the rising cost of necessities, stagnant wages, an absence of family supporting wage jobs, and slowing GDP (it was 3.9 percent in the second quarter 2015, 2.1 percent in the third), where are the signs of an overheating economy that needs to be slowed?

So, what we have here is the Fed raising interest rates, and starting a rising rate cycle, during a period of time with no elastic product/service inflation, no meaningful job growth, and slowing U.S. Gross Domestic Product. Did IQs suddenly drop?

And let's understand, rising short-term interest rates will slow the economy. This is not a macroeconomic growth move by the Fed. It is disinflationary, perhaps deflationary, is a contraction move for the economy. Borrowing costs for households with home equity loans, credit card loans, and student loans just went up, cutting into already strained household budgets. Borrowing costs for small businesses with lines of credit tied to prime just went up, increasing earnings pressure. Margin debt just got more expensive. And make no mistake, bank deposit rates will not go up as much as the Fed just raised interest rates. If lending rates just went up a quarter percent, depositors will be lucky to see an increase of $1/10^{th}$ that amount. It ain't gonna happen. The rate increase will not benefit savers, as banks are flush with deposits. They are not about to raise deposit interest rates any time soon.

The U.S. monstrous debt service cost will now go up. Interest rates on short-term Treasuries will rise, increasing the Federal Deficit. Is that a good thing?

Make no mistake, the Fed is now tightening the money supply, removing liquidity from the markets and economy. What this means is money will flow from the economy to the Fed. The Fed does not count; it contributes nothing to our economy. If money is at the Fed, it is gone from the economy. Money and Banking 101. The way the Fed raises interest rates is to sell securities it holds in its balance sheet to Wall Street in exchange for U.S. Dollars. That means less money to be lent or spent in the economy. Less money for a growing population. But there is more here than meets the eye. A lot more, for we see that the Fed is actually tightening the money supply in two significant ways, first by the above increase in the overnight funds rate, but second, and this is a biggie, the Fed is unwinding its humongous balance sheet.

How? What? Over the past decade, the Fed printed $5.0 trillion of cash out of thin air, and gave it to Wall Street in exchange for securities that were held by Wall Street and the economy. In other words, the Fed traded new money going to the Manhattan economy for IOUs coming back to the Fed, some mortgage securities, some government securities, who knows exactly what, probably a lot of junk. Well, these securities became the bulk of the Fed's balance sheet, which ballooned to a whopping 19 percent of U.S. GDP. But you see, those securities required corporations and government entities to eventually repay cash to the Fed in the form of stated interest rates on those securities, and principal redemptions. In essence, money flowing out of the economy into the Fed, a tightening of the money supply. Further, those securities are maturing, meaning the Fed gets paid money for redemption upon maturity of the securities in its balance sheet. Again, money flowing out of the economy into the Fed.

The point is, the Fed is tightening with the raising of interest rates at the same time it has an outlier outrageous balance sheet full of maturing interest and principal in securities it holds. This tightening could hit our economy like a tsunami, a massive withdrawal of liquidity from the economy in the face of commodities deflation (never happened before) and a slowing economy (only happened twice before with disastrous economic and stock market repercussions). The Fed screwed up, royally. Just watch what happens over the next year. It ain't gonna be pretty.

Let's call it what it is, we have a bunch of unelected professors running the economy, most of whom never ran a business, never held a real job in their lives. They occasionally pop out from their ivory towers with an arrogance that would freeze a lava flow. They decide our fate with their interest rate policies, and their over-regulation, and their behind the scenes market manipulation for political gain and derrière enshrinement.

What is funny to me is, this is precisely what the two Jaws of Death patterns we are tracking are telling us, that events will come that kick the snot out of the economy and the stock market. Well, count the Yellen Fed as one of the contributing causal factors in the Great Recession / Depression of 2016 through 2020.

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Dr. McHugh's book, "The Coming Economic Ice Age, Five Steps to Survive and Prosper," is available at amazon.com at http://tinyurl.com/lypv47v

"Jesus said to them, "I am the bread of life; he who comes to Me shall not hunger, and he who believes in Me shall never thirst.
For I have come down from heaven,
For this is the will of My Father, that everyone who beholds the Son and believes in Him, may have eternal life;
and I Myself will raise him up on the last day."

John 6: 35, 38, 40