NEVER FADE THE MONTHLY STO

All professional traders are familiar with the notion of "fading the market." Investopedia defines it in the following way:

Definition of 'Fade'
1. A contrarian investment strategy used to trade against the prevailing trend. "Fading the market" is typically very high risk, requiring the trader to have a high risk tolerance. A fade trader would sell when a price is rising and buy when it's falling. Also known as "fading".

The concept above is of particular relevancy as of this writing *(February 07, 2014)* because an extremely rare occurrence is evolving, an eventuality that will come to fruition within the next 8-12 weeks and that will controvert the conventional wisdom espoused by the majority of the economic punditry. What is it, you ask? Before I hurtle headlong into this apercu, it would be advantageous to bring up to speed those readers who are not familiar with the basics of in the universe of technical analysis. May I commend to those neophytes a squib that I penned 16 years ago. That effort will well serve as a primer for those unfamiliar with Stochastic analytics, but will also impress the relevancy of its predictive value as germane today as it was then. Simply click on www.stomaster.com/stodolie.pdf to be instantly transported to that hornbook.

The Monthly Sto has recently touched a low K/D reading, the order of magnitude of which has only been marked four times since the inception of trading in the 30 year Treasury bond future almost 40 years ago.

It is seen from the chart below that the Monthly Sto is currently on the cusp of a once in a decade upcycle, to be catalyzed by a prospective upcross in its K/D. Recall that the consequent upcycles and downcycles of the Monthly Sto have an average duration of 12-15 months. However, crosses originating from either extreme low or high readings K/D will generally extend duration beyond the average. Let's examine an example from the chart, the first entry of which will do nicely. Note that on 9/1/1981, with the price of the 30 year Treasury bond in the basement at 45^24, having been bludgeoned for 15 months (ah, shades of the Federal Reserve's Chairman Paul Volcker and his "no prisoners" attack on inflation), the Monthly Sto's K/D reading hit an extraordinary low of 11.50/15.63 K/D. That signal and singular event was quickly followed by an upcross and subsequent 21 month upcycle run to a high of 66^12 on 5/2/1983.

The argute and astucious reader will observe that the other three observations of historically low K/D readings indicated by the horizontal red line share uncannily similar preceding and subsequent time durations and resulted in consistently identical outcomes: to wit, robust rallies marking outsized price gains of 20+ points.

30 YEAR BOND PRICE/STOCHASTIC CHART

↑ = MONTHLY STOCHASTIC CYCLE LOWS

MONTHLY STO HISTORY OF ALLTIME LOW K/D'S

DATE	LOW PRICE	DATE	HIGH PRICE	# UP MONTHS	TOTAL GAIN	LOW K/D	# DOWN MONTHS
9/1/1981	45^24	5/2/1983	66^12	21	20^20	11.50/15.63	15
7/2/1984	49^08	4/1/1986	87^16	22	38^08	14.87/24.12	13
11/1/1994	79^21	1/2/1996	101^1	15	21^21	17.27/24.25	13
1/3/2000	89^00	11/1/2001	89^00	23	33^18	13.30/16.99	14
1/1/2014	**128^02**	**?**	**?**	**?**	**?**	**17.49/25.66**	**14**

As of 02/07/2014, the Monthly Sto has contracted its negative K/D to 22.13/25.35 K/D after registering a low K/D reading the first week in January of 17.49/24.66 K/D. As seen on the graph, %K *(the blue line)* has uphooked and puts it on the cusp of an imminent upcross and early warning of the commencement of a secular bull market. Students of Stochastic Analytics will recognize that in order for the upcross to be valid (i.e. to “validate”), the K/D reading must be in the upcrossed position on the last day of the month in which it upcrossed. That event is known as “memorialization” in the world of stochastics. It is anticipated that this memorialization will happen sometime at the end of this month (February, 2014) or at the latest, March, 2014. What will be the catalyst for this signal secular change in the direction of interest rates? Any number of fundamental suspects as briefly discussed below could serve as the flashpoint. But it is this observer’s opinion that it will be of international origin rather than domestic. And the fail may either be cresive or traumatic, but in either case will result in a headlong flight to quality into the instruments that when all is said and done remain paramount…U.S. Treasury debt.

SOME FUNDAMENTAL STUFF

For those who believe that the Fed’s tapering will result in higher interest rates on U.S. Treasury debt, it would be wise to think again. The international capital flows extant make the Fed’s paltry incremental $10 billion decrease in purchases of Treasuries, or even the entire remaining $35 billion commitment to those purchases, pale in comparison to the international flight to safety demand that will fuel the coming bull market in Treasuries. Why a flight to safety? The Fed’s FOMC statement on January 29, 2014 indicated that it believes the economy will continue to expand at a moderate pace; to wit:

> *"The Committee expects that, with appropriate policy accommodation, economic activity will expand at a moderate pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate."*

Perhaps that assessment would be accurate if the U.S. economy were closed and not subject to the vagaries of international trade and capital flows attendant with the inevitability of pesky unintended consequences. But perception trumps reality when it comes to trying to suss out the intentions, actions and consequences of the Fed’s agenda. The international economic community is intimately connected and interdependent. With the phasing out of QEIII, or even just the expectations of that exit strategy, tremors are felt around the globe. Hairline cracks in the forex markets are turning into crevices as currencies become increasingly vulnerable. Witness the untoward economic reverberations in countries such as Turkey, Brazil, Indonesia, South Africa and India, once thought of as the darlings of emerging markets, now are fast becoming the pariahs as they are redesignated with the appellation “The Fragile Five.” Why? Because with the Fed’s adoption of the massive QE regimes, these countries became dependent on the nurturing inflow of debt and equity capital to galvanize and sustain their growth. That subvention was and is like the umbilical cord in a mother’s womb to her baby. Cincture it and the baby suffers duress. In the case of the “Fragile Five”, unrelenting flight of capital, hot money if you will, has bludgeoned their currencies, the denouement of which could easily result in deflation and economic deterioration. As the estimable analysts at the preeminent firm of Morgan Stanley wrote last August 2013:

> *"High inflation, weakening growth, large external deficits, and in some cases exposure to the China slowdown, and high dependence on fixed income inflows leave these currencies vulnerable."*

That is a daunting prospect given that the Fragile Five contribute 14% of world GDP, a larger share than Russia and France combined. Add to that China's shadow banking credit crisis triggering a deceleration in growth, the ever unpredictable European morass of the peripherals fomenting another round of debt crises and finally, gestating and very real qualms about continuing growth (i.e. slowdown) in the U.S. economy and you have the calculus of some disturbing, disarming, disaffecting disasters waiting to happen.

It is beyond the scope of this paper to explore in detail the nuances and subtleties of the economic forces that the Sto is predicting will bring to bear on interest rates. To that end, I would highly recommend that you check out John Mauldin's extremely informative, analytical and insightful weekly macro-economics letter entitled *"Thoughts from the Frontline"* and which astutely and concisely fleshes out the fundamental concepts referenced above. John is on the same page as the Monthly Stochastic in his belief that 2014 will more likely witness a decline in interest rates rather than a rise. Below is a sampling of his thinking written January 2014:

> *"For interest rates to rise much from here, either inflation needs to pick up, or there must be a disconnect between the normal relationship between inflation and interest rates. This is just one of the reasons that analysts like Lacy Hunt continue to believe that the longer-term bias for interest rates is down.*
> *So, an actual forecast? With the caveat that I don't have a real clue but am just trying to make an educated guess? Unless there is something that spikes the price of energy, inflation will stay low, and I think that's going to be an anchor on the rise in interest rates. Which means that yields will stay down, and the reach for yield that has been so evident in the markets for the past few years will continue to be a dominant factor. That means credit spreads will tighten even further, though that still wouldn't take them outside historical boundaries.*
> *And those factors give the longer-term direction of the market an upward bias – after we have a correction sometime this year. Are we in the midst of that correction now? Possibly."*

And

> *"Will we have an outright recession in the US this year? I currently think that is unlikely unless there is some kind of external shock. But short-term interest rates will stay artificially low due to financial repression by the Fed, and there will be an increased risk of further monetary creativity from a Yellen-led Fed going forward. Stay tuned."*

John's Weekly offerings are free and it is well worth checking them out at by subscribing at: https://www.mauldineconomics.com/members/login

John also embraces the notion of a fraternity of scholarship as he invites other notable commentators to post on his site. An example of this epistemic camaraderie is exemplified below in a piece penned by his good friend and business partner, Niels Jensen, in John's weekly *Outside the Box* publication and entitled "Challenging the Consensus."

> *"In the December 2013 Absolute Return Letter ('Squeaky Bum Time') I discussed our 2014 expectations for equities – see here. This month I will focus on the outlook for interest rates and challenge the prevailing wisdom – i.e. that rates are destined to rise as 2014 progresses. I am not suggesting that the consensus view will definitely prove wrong in 2014; however, I can think of at least five plausible reasons why many may end up with a little bit of egg on their faces as interest rates fall before they rise."*

http://www.mauldineconomics.com/outsidethebox/challenging-the-consensus

And Lacy H. Hunt, from Van Hoisington Management's Quarterly Review and Outlook, 2nd Quarter 2013 written July 2013:

> *"The secular low in bond yields has yet to be recorded. This assessment for a continuing pattern of lower yields in the quarters ahead is clearly a minority view, as the recent selling of all types of bond products attest. The rise in long term yields over the last several months was accelerated by the recent Federal Reserve announcement that it would be "tapering" its purchases of Treasury and mortgage-backed securities. This has convinced many bond market participants that the low in long rates is in the past. The Treasury bond market's short term fluctuations are a function of many factors, but its primary and most fundamental determinate is attitudes toward current and future inflation. From that perspective, the outlook for long term Treasury yields to fall is most favorable in light of: a) diminished inflation pressures; b) slowing GDP growth; c) weakening consumer fundamentals; and d) anti-growth monetary and fiscal policies."*

http://www.mauldineconomics.com/editorial/outside-the-box-hoisington-investment-management-quarterly-review-and-outlo

AND THE MONTHLY STO AGREES

For the purposes of this technical analysis précis, however, suffice to say that the Monthly Sto has proven itself as a reliable harbinger, an *avant courier* of economic events and forces that will intrude to drive interest rates lower in the next secular bullish turn in the interest rate cycle. The average duration of this cycle has proven to be 12-15 months and based on prior experience, will see the 30 year Treasury bond rally 28 ½ points for a total yield decline of 142.5 bps. The 10 year Treasury note will experience roughly 50% of the long bond's price appreciation, or a 14 ¼ point rise which translates into a 171 bps decline in yield. From the high yield marked at 3.02% in late December, that move would represent a yield objective of 1.31%. Outrageous you say? Perhaps. But the one irrefutable, incontrovertible fact is that there WILL be a significant rally of a magnitude totally unexpected by the received wisdom of the Street's *cognoscenti*, the majority of whom are prognosing higher, not lower interest rates.

CONCLUSION

I would urge readers to review a position paper I wrote back in 2012 addressing the interest rate ramifications as a result of the ending of QEII. The logic and conclusions offered in that write-up are equally as valid in the instant case of the termination of QEIII.

For those motivated readers, you can access it at www.stomaster.com/TheEndofQEII.pdf.

In the universe of investments, we are always warned that "past performance is not an indication of future results." Surely that would be an appropriately cautionary admonition even for stochastic analysis. But the Monthly Sto is telegraphing an event that has been witnessed only four times in the last 37 years. At this milestone moment in stochastic history, it will be wise to remember the words of a bowdlerized Ecclesiastes 9:11, to quote:

> ***"The race is not always won by the swiftest, nor the war by the strongest….but it pays to bet that way."***

**"Those who would covet,
Great wealth to be made,
Dare not on their life,
The Sto Monthly to fade."**

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*Other techs might seem to fly,
But in the end, the Sto don't lie.
No, in the end, the Sto don't lie.*