US Heading Into A Perfect Storm, Market Watch Reports.

The perfect storm

By John Nyaradi

Syria, next week's Fed meeting and the upcoming debt ceiling battle set up a perfect storm for global financial markets.

Syria remains a fast-moving and fluid situation, as first the "fear" trade took hold, sending equity markets lower and gold and oil higher. Then, virtually overnight, a diplomatic solution is now on the table and the "fear trade” is currently unwinding, at least for the time being, as world governments explore the Russian proposal for disarming Syria of its chemical weapons. Expect the twists and turns of this drama to continue whipping financial markets over the next few weeks.

Sept. 17-18 brings the long-awaited Federal Reserve meeting, Bernanke press conference and the anticipated beginning of the end for quantitative easing. The latest noise from Wall Street Journal columnist John Hilsenrath points to a "dovish taper" after last week's nonfarm payrolls report came in weaker than expected.

The latest rumblings point to a small reduction in the Fed's bond-purchase program to the tune of $10 billion/month, which would reduce the program from $85 billion to $75 billion and leave options open for future action depending upon the strength of the economy and employment.

Clearly the Fed is nervous about the impact of pulling the "punch bowl" of easy money, as previous attempts were met with less than a joyous reaction by U.S. stock markets

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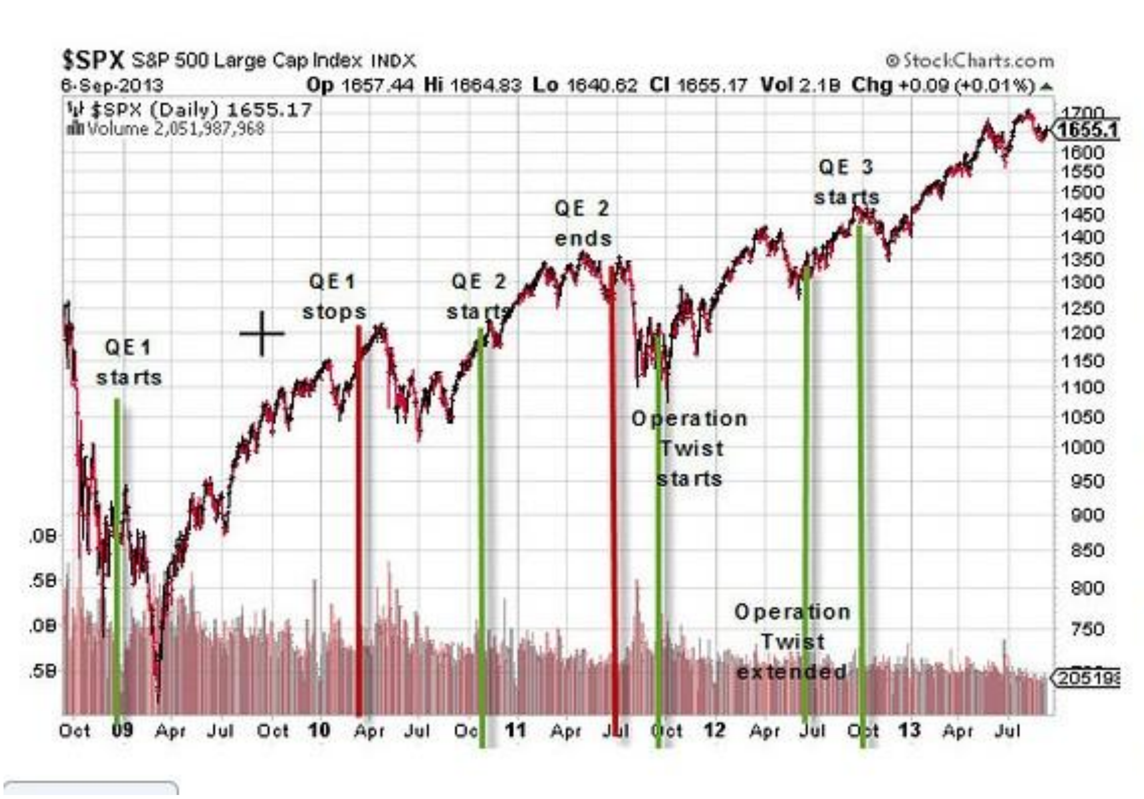

The chart to the left demonstrates that after the first phase of quantitative easing ended on March 31 of 2010, the S&P 500 Index fell from 1,217 on April 23 to 1,022 on July 2 of that year. When the second phase of quantitative easing was completed on June 30, 2011, the S&P 500 fell from 1,339 to a low of 1,123 on Aug. 19. On April 27, 2012, before Operation Twist was extended, the S&P began to fall from 1,403. By June 1, 2012, the S&P was down to 1,278.

The third and final phase of quantitative easing began on Sept. 13, 2012, when the S&P 500 was at 1,459. Since that time, the S&P has climbed all the way to 1,671, thanks to the Fed's liquidity pump. The pressing question concerns the degree to which the S&P 500 could retreat when plans to cut back on the bond buying are announced, and it becomes clear that QE4 might not be on the horizon.

Finally, another round in the debt-ceiling battle is set to start with the government potentially running out of money sometime between mid-October and mid-December when its extraordinary funding measures reach their limits.

The last debt-ceiling battle occurred in the summer of 2011, and from late July to September, the S&P 500 shed more than 15% as Congress and the White House wrangled over a settlement. With the House seemingly intent on tying a lift in the debt ceiling to limits on Obamacare, this round of debate could be even more rancorous.

Technical indicators point to the market's general confusion.

In the second chart, we can see how the S&P 500 put in a recent bottom as the "fear" trade came to a sudden end, and now momentum and relative strength are again positive. Nevertheless, significant resistance lies just ahead and this ceiling must be broken before the resumption of the uptrend can be confirmed.
So our current situation sees fundamental and technical factors coming together to create The Perfect Storm. If everything goes well, that is, Syria hands over its weapons, the Fed does "taper light" and Congress and the White House can come to a quick conclusion on the debt ceiling debate, it will be a solid green light for the stock market.

On the other end of the spectrum, military action in Syria, an adverse reaction to withdrawal of easy money by the Fed or a standoff between the House and the White House over the debt ceiling lead to potentially rough waters and big waves ahead for global financial markets.

Anywhere in between generates large primary and secondary swells on an already turbulent sea.

Within the next two to four weeks, the contours and impact of the perfect storm will become more defined and will likely set the stage for a significant market move in one direction or other. Will you be ready? Wall Street Sector Selector is in "yellow flag" status, expecting choppy conditions ahead.