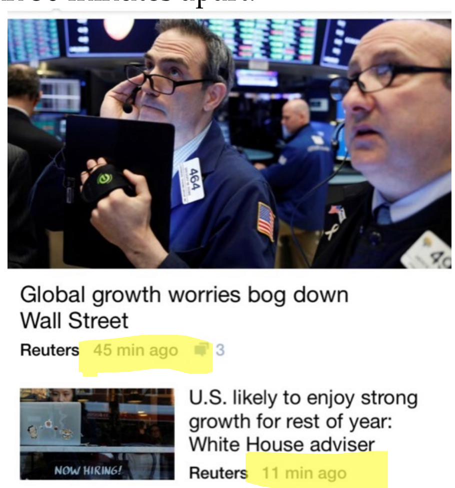
April 8, 2019

The Bulls and the Fed's Red Cape

News outlets use headlines to grab the reader's attention. With so many competing mediums disseminating information today, it seems the more dramatic the better. The financial press thrives on quotes, short articles, and anecdotes that may explain swings in the stock and bond markets. There are even contradictory rationales from the same source! Here are headlines put out by Reuters a little more than 30 minutes apart:

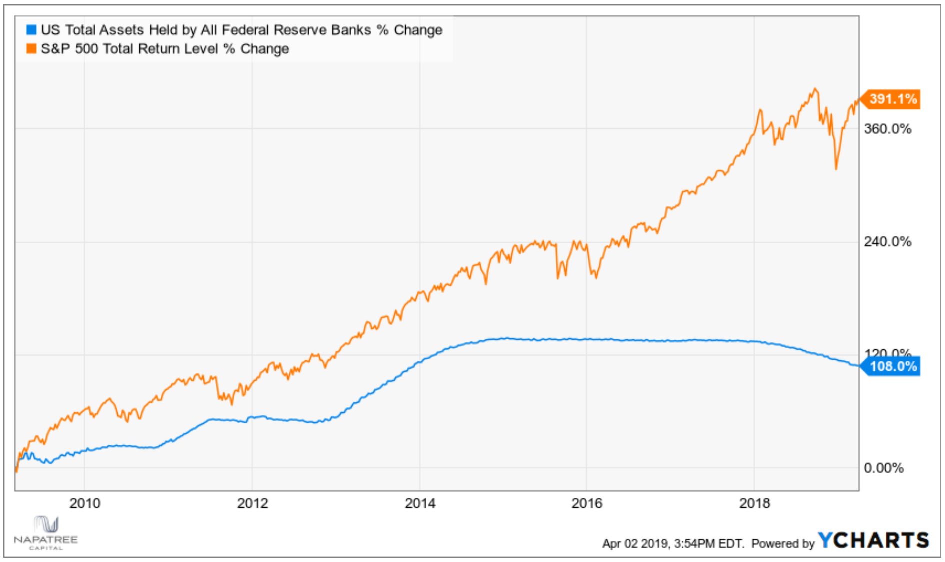


Which is it? Is economic growth slowing or is it strong? Are the markets worried about that? Did this White House adviser learn something in the 34 minutes since Reuters released the news about global growth concerns? It is enough to make one's head spin.

<u>Providing Liquidity: Expansion of the Fed's Balance Sheet</u>

There ***is*** an influential force in the markets today, however, which seems to have real sway over stock and bond prices: the U.S. Federal Reserve Board, or the Fed. The Fed has several monetary tools that work either to stimulate a slowing economy or keep an economy from overheating. We hear about interest rate cuts or interest rate hikes, but the Fed also participates in the buying (and selling) of U.S. Treasuries. In the case of quantitative easing, which began in the autumn of 2008, the Fed took aggressive actions to support the economy and provide liquidity to markets in several ways. For now, we will limit our analysis to the Fed's purchase of U.S. Treasuries, which provides liquidity to financial markets and increases the assets on the Fed's balance sheet.

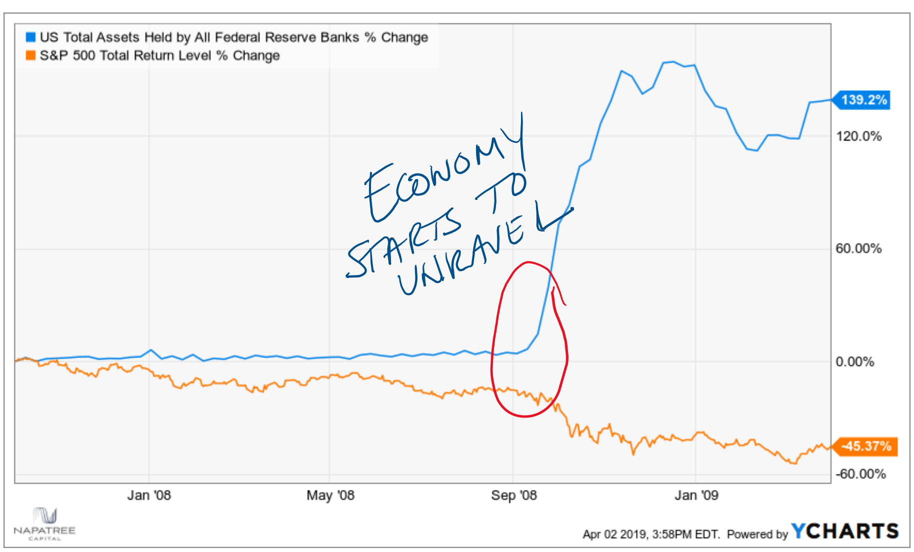
Here is an illustration of the total appreciation of stock prices (S&P 500), and the expansion of the Fed's balance sheet, from March 2009 (the stock market low during the Great Recession) through March 2019:



Hopefully the financial crisis of 2008-2009 was a once-in-a-half-century-event, because the Fed had to use a lot of firepower to pull the U.S. economy back from the brink of disaster; doubling the size of its balance sheet was one result. From March 2009 to the end of the first quarter of 2019, the S&P 500 had expanded nearly fourfold. It's hard to argue a correlation between stock prices and the Fed's actions. Let's investigate further.

From Bear to Bull

Prior to the financial crisis, the previous bull market peaked in October of 2007. This graph illustrates the relationship between the S&P 500 and the Fed's balance sheet during the crisis, from that 2007 top to the market bottom in 2009 (the start of the previous illustration):



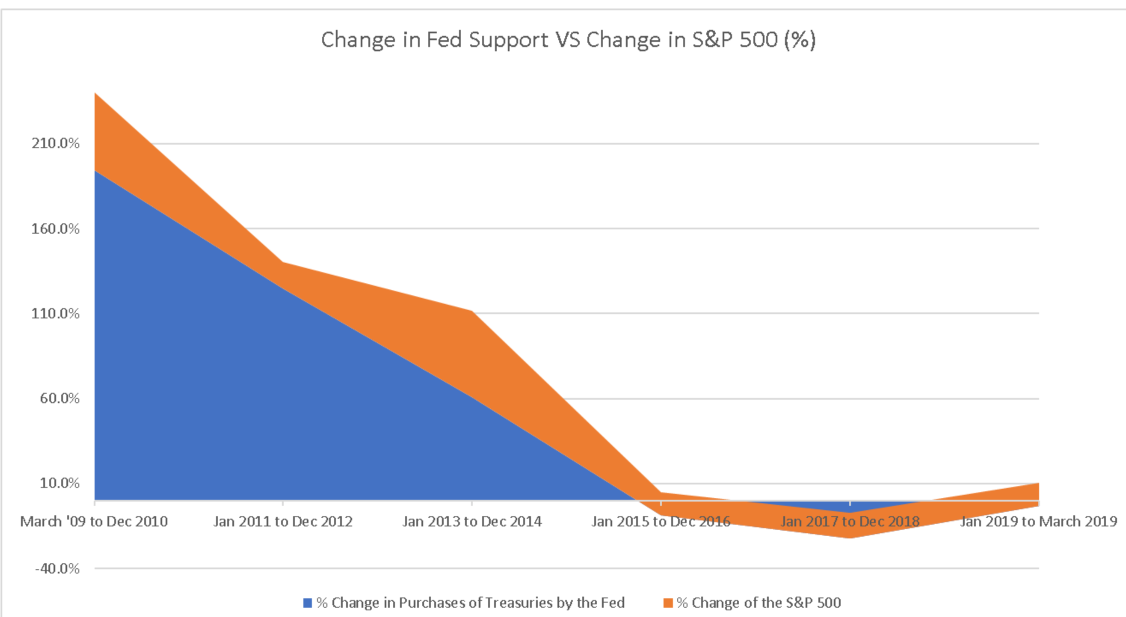
As the equity markets began to collapse in the fall of 2008, the Fed acted. It was quick and very aggressive. In three months' time the Fed increased its assets by nearly 157% through purchasing Treasuries in the open market during the market's continued slide.

We love to pull apart data and look for some significance. We sliced up the Fed's actions in different time periods to see if there was added evidence of a correlation with stock prices. Taking five different time periods, I compared the change in Treasury purchases by the Fed to the change in the S&P 500. Further, I split the data into two segments: when the Fed has been supportive and when it has begun to be less accommodative (presently):

Period	% Change in Purchases of Treasuries by the Fed	% Change of the S&P 500	Growth of $10k	Avg Return
March '09 to Dec 2010	194.5%	45.5%		
Jan 2011 to Dec 2012	124.7%	15.7%		
Jan 2013 to Dec 2014	61.0%	50.5%	$ 25,341	26.5%
Jan 2015 to Dec 2016	-8.8%	13.5%		
Jan 2017 to Dec 2018	-22.1%	14.8%		
Jan 2019 to March 2019	-3.1%	13.5%	$ 14,793	11.3%

FED SUPPORT

The last ten years have been nothing short of a bonanza for stock investors. However, clearly the returns have not been as robust since the Fed stopped buying Treasuries in the open market, sometime in late 2016. Here's another depiction of this same data:

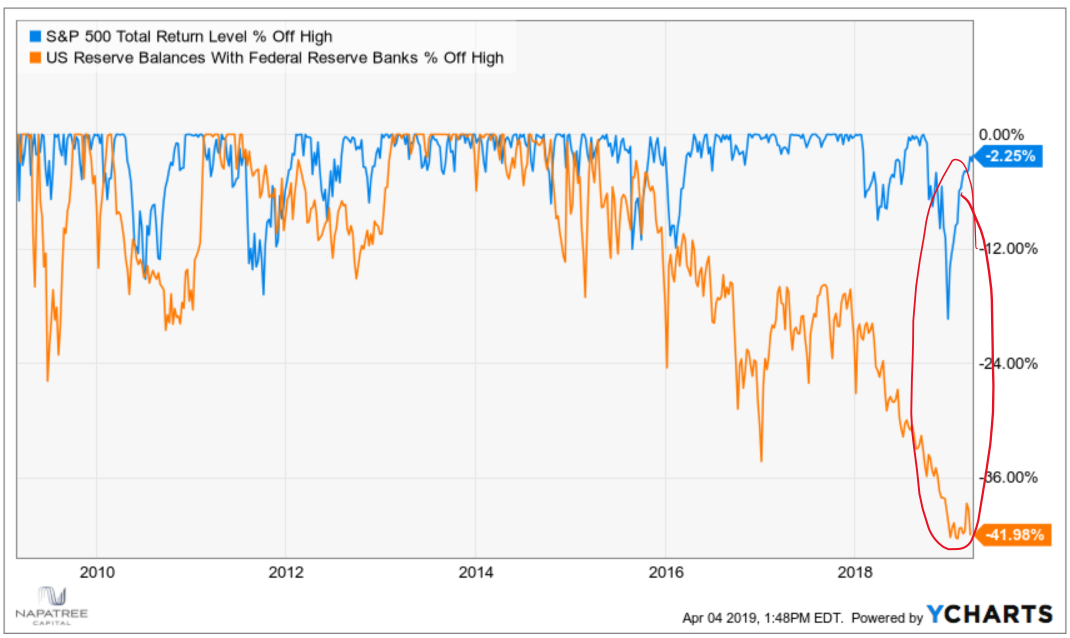


Based on the previous charts, it seems that a meaningful relationship between the Fed's balance sheet and stock prices exists. A common phrase on Wall Street trading desks is "don't fight the Fed." We can see why.

The heart of the matter is…should we be concerned? Before we provide an answer, a disclaimer about statistical analysis.

> *There are many variables that affect an outcome. The stock market is comprised of thousands of public companies with different earnings and balance sheets that affect their share price. Additionally, the macroeconomic climate influences how these companies earn profits and how investors react to financial markets. This leads to another major factor: the psychology of market participants. This commentary is not a comprehensive analysis of data using the full complement of statistical methods. However, pictures, in this case, can be powerful tools. We think it is a useful way of trying to make sense of something that is talked about quite often in financial media.*

One final chart. The change in the S&P 500 relative to the change in the Fed balance sheet since March 2009 expressed as a percentage of an all-time high:



Now the answer: it matters. We need to be paying very close attention, not only to what the Fed does, but what is said. Perhaps the economy is strong enough so that it no longer requires support by the Federal Reserve. Maybe the stock market, down only marginally from recent all-time highs, is indicating an ability to stand on its own two feet as support wanes. The previous chart may be an indication of that. One opinion that most analysts and economists agree upon, however, is that as the economy and markets enter this “new” period, stock market volatility near the time of Fed meetings will likely be heightened. We will have to wait and see, but the gap between changes to the size of the Fed balance sheet versus changes to highs in stock prices has never been wider.

In Conclusion: The Volatility Shakeout

From the first week of October last year to Christmas Eve, the S&P 500 contracted by a whopping 19%! Granted, it had recently notched an all-time high, but the pullback was quite severe in such a short amount of time. It was a dizzying time for investors, with no lack of headlines purporting to give reasons for the sell off. But what exactly happened?

A major factor was the focus on the fourth quarter meeting of the Federal Reserve. On December 19, Jerome Powell, the Fed Chair, announced a 0.25% hike in short-term rates. But the rate increase surprised investors because most had begun worrying about a *slowing* economy. The Fed had already been reducing liquidity up to that point to keep a lid on inflation as the economy had achieved full employment. Another rate hike didn't seem necessary. Between the December19 announcement and the December 24 low, stock prices continued to drop precipitously, diving another 9% in four trading sessions after having fallen nearly 14% since October. The market felt a move by the Fed was unnecessary, as evidenced by the weakness in stock prices. Panic ensued, causing a bottom, which is commonly how stocks find support[1]. Consequently, in the first quarter of 2019 the S&P 500 has appreciated 13.7%.

The bottom line: actions by the Fed will be subject to increased scrutiny and likely increased volatility. The "backstop" is being gradually taken away. Sensitivity of financial markets to Fed actions is quite high. But staying the course is warranted. The market seems to be in a new era that encompasses benign intraday moves for extended periods as well as more violent intraday moves in much shorter periods. Don't get shaken out. Be patient and ignore the headlines.

Understanding the data and taking the long view is how we approach investing at Napatree Capital. Hopefully it helps us keep you on the disciplined path.

Jeff

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[1] Please see our December commentary, "A December of Extremes", discussing the panic situation. It can be found on our website at http://www.napatreecapital.com/napatree-viewpoints/ or in the client portal.

An Important Note About Our Investment Philosophy

Our research team works diligently to try and understand what a market is discounting. We believe in taking positions that may be contrary to what you see or hear in the financial press. For example, an increased weighting to international markets at a time when there is continued uncertainty around Brexit and heightened fear of a global economic slowdown may seem counterintuitive. We believe that such times offer opportunity. As value investors our discipline is not chasing the "hot hand", instead relying on fundamental and quantitative analysis that allows us to remain patient for the markets to realize the full value of our investments.