Perspectives

MAY

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Don't Fight the Fed

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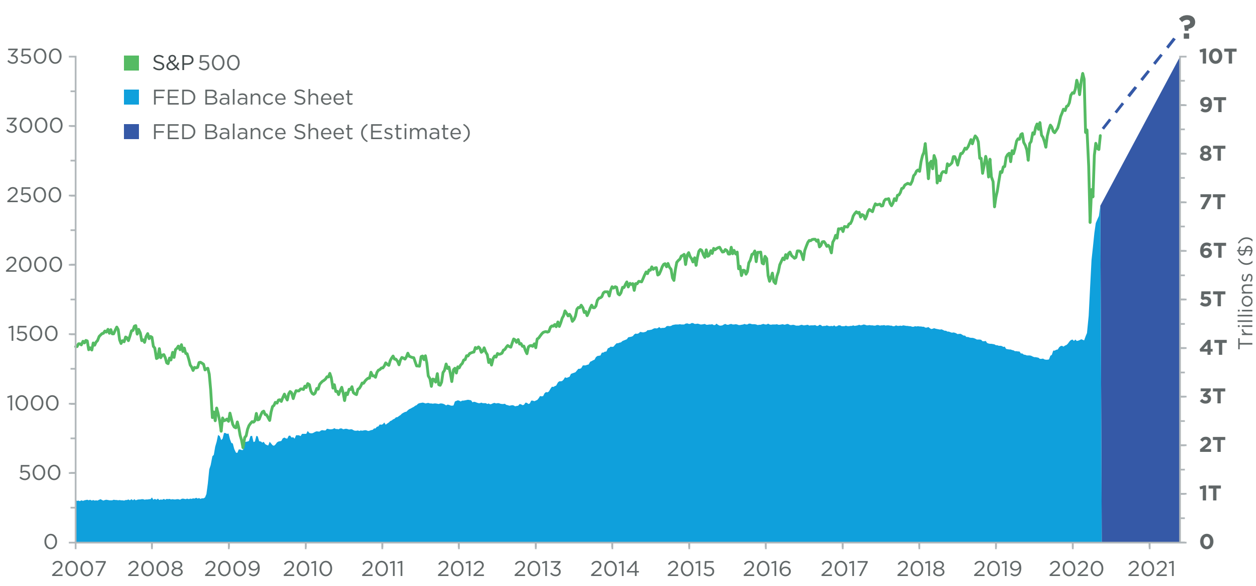
capital management

Famed investor and market forecaster, Marty Zweig, coined the phrase, “Don’t fight the Fed,” in 1970, explaining that Federal Reserve policy has a strong correlation in determining the stock market’s direction. As simplistic or cliché as the phrase may seem, investors who followed that advice have been on the right side of history. Since December 2008, when the Fed started increasing their balance sheet in size, a.k.a. Quantitative Easing (QE), the S&P 500 has had a correlation coefficient to the Federal Reserve’s balance sheet of .8093[i]. The correlation coefficient ranges from -1.00 to +1.00 and illustrates the dependence these two variables have on each other. Although correlation does not equal causation, the relationship between the S&P and the Fed’s balance sheet is compelling.

The speed at which the Fed reacted to the COVID-19 crisis is historic, unprecedented, and experimental. Prior to the Great Financial Crisis of 2007-2009, the conventional tool the Fed used to manipulate the economy was changing the federal funds rate. On March 15, the Fed lowered rates one full percentage point to the zero bound range of 0-.25%, and stated that they were prepared to use their full range of tools to support the economy (the Fed’s version of “shock and awe”). The alphabet soup of programs[ii] announced since March is a mix of the tools used during the 2007–2009 crisis and new ones, like



Source: Bloomberg

the Main Street Lending Program, a facility that will make loans to non-financial companies (a first for the Fed). The Fed's balance sheet expansion has been historic, growing from ~$4.2 trillion mid-March to over $6 trillion (10 times its size in 2007) in under two months. By 2021, the balance sheet could grow to over $10 trillion.

History of the Federal Reserve Balance Sheet			
Span of Time	**Time Period**	**Beginning Balance**	**Ending Balance**
95 years	1913–2008	0	$900B
7 years	2008–2015	$900B	$4.5T
2 months	Mar 2020–May 2020	$4.2T	$6.9T

Source: Federal Reserve, Bloomberg

It is difficult to conceptualize a trillion dollars. A billion seconds is roughly 31 years, a trillion seconds is 31,000 years! Regardless of the unintended consequences, Chairman Powell has been clear: "the one thing I can absolutely guarantee is that the Federal Reserve will be doing everything we can to support the people we serve. There is a lot more can we do. There is no limit to what we can do with these lending programs."[iii]

The human toll the virus and the shutdown have caused is real and the economic data coming in is only comparable to the Great Depression. Learning from history and not wanting to have a repeat of the 1930s, the Fed stepped in with gold medal speed in an effort to immunize the economy and to limit the potential long-term damage caused by shutting down the economy. The Main Street Lending Program (MSLP) is one of the announced yet unimplemented programs that looks to be rolled out imminently.

The MSLP will start at $600 billion. Historically, the Federal Reserve does not lend to non-financial companies, so this program is a first. Although very complex in execution, the objective is clear: get money into the hands of actual businesses that are the fabric of the economy. Businesses do not directly benefit when the Fed buys Treasuries or expands US dollar swap lines for foreign central banks. The MSLP looks to directly help these businesses. Unlike the Payment Protection Program (PPP) which was aimed at small businesses, the minimum loan size of the MSLP is $500k and companies have more flexibility than the PPP, as they can use these loans for many purposes, including refinancing their own debt. As with all things, the devil is in the details, but on the surface, programs like MSLP show how committed the Fed is in making sure the economy is awash in capital.

Asset Classes with Federal Reserve Participation
Treasuries
Agencies
Agency MBS
Money Markets
Municipal Bonds
Investment Grade Corporate Bonds
Fallen Angels*
Asset Back Securities**
AAA CMBS
Collaterized Loan Obligations
Bond ETFs***

Source: Federal Reserve

Winston Churchill stated, “Those who fail to learn from history are condemned to repeat it.” Jay Powell clearly learned from the mistakes that were made from the 2007–2009 financial crisis. In the summer of 2007, fed funds stood at 5.25%; it was not until December 2008 that the target rate reached zero. In addition, the unconventional programs and facilities rolled out were gradual. In contrast, in under a month, the Fed cut rates to zero, began unlimited Treasury and MBS purchases and rolled out programs and facilities controlling everything from money markets to high yield ETFs.

The Fed has been clear, they will not let the U.S. economy fail and will use all their tools to make sure the U.S. lands on solid footing.

What about the S&P 500? One main theme we continue to hear from clients is the massive disconnect between the stock market and the economy. How can the S&P 500 only be -13.5%[iv] from its all-time high, when the economy is shut down and jobless claims are at 27 million[v] and growing? As allocators of capital we try to remain dispassionate and look to understand what the market is telling investors versus the futility of attempting to fight the realities that at times, make no intuitive sense. Pragmatically, the industries that have been devastated are hotels and tourism, airlines and cruises, entertainment, restaurants and bars, retail ex-food and beverage. Collectively in 2019, these industries only made up 7% of operating earnings of the S&P 500[vi]. These industries are critically important to the real economy but their impact on S&P earnings is muted. For 2020, consensus earnings estimates for the S&P 500 are $125, but the range is wide and the market seems more focused on 2021. We would not be surprised to see Q2 earnings come in negative. Q1 earnings only captured a couple of weeks of the shutdown, while Q2 will most likely be the eye of the storm. In addition, it seems the market is expecting a vaccine much sooner than what the experts were forecasting just last month.

S&P 500 Earnings Per Share

Firm	2019 (Act.)	2020 (Est.)	2021 (Est.)
Street Consensus[vii]	$161	$125	$161
JPM	$161	$126	$164
Fundstrat	$161	$50	$193

Per Tom Lee, at fundstrat, “according to the WHO, there are 8 vaccines in clinical evaluation today and 110 in preclinical evaluation. This is 118 shots at creating a vaccine.” In addition to the current sentiment that a vaccine will be found sooner rather than later, money market assets have grown by 30% this year to $4.7 trillion. From a contrarian perspective, extremely high levels of cash on the sidelines are bullish. Anecdotally, the mountain of cash on the sidelines is another piece of evidence that the stock market can go higher.

Words matter. Although the Fed was quick to react, the complexities of the facilities that were created “on the fly,” have taken longer to implement. As of today, the Fed has launched less than half of the programs that were announced in March and April, and though they said they were going to purchase investment grade and high yield ETFs, the purchases so far have been minuscule. The mere statement was enough for markets to rally 30% from the lows. The Fed has stated that they expect the remaining programs to be running by months' end. By year end, the Fed purchases could equal roughly 20% of the US Aggregate Bond Index, which equal roughly one-third of GDP and equate to 28% of the market cap of the S&P 500[viii]. It is estimated that the Fed balance sheet could grow to over $10 trillion in 2021, a ~40% increase from where it stands today. These actions should create a seismic tail wind to equity markets. Marty Zweig's simple logic of following the Fed has been consistently and unsuccessfully challenged over the year by the most sophisticated of investors. We believe there can be sophistication in simplicity and although volatility is evergreen and will rear its head again, the power and clear intent of the Federal Reserve is not one we would bet against.

We are in uncharted waters. In modern times, we have never had to deal with a pandemic which has brought not only the health of the economy, but the health of the nation, to its knees. At the same time, we are living in a golden era of science where we have the technology to sequence a virus in less than two days. Economically, the fiscal stimulus and the role the Federal Reserve is playing in this crisis cannot be dismissed. There will be long-term consequences of the massive monetary and fiscal stimulus, but we will leave those for another day (hint: why we own gold).

We have experienced a full market cycle of emotions in 90 days. The psyche of the market has gone from euphoria "way back in February," to anxiety, denial, fear, panic, capitulation (March 23), despondence, depression, hope (where we are today), relief, then optimism. We are not in normal times. Regardless of the unknowns that the rest of the year will bring, we are once again reminded that **time in the market, not timing the market, is the key to investor success.**

We believe in allocating to both public and private market investments. The massive monetary and fiscal stimulus should benefit both markets. While our private market investments have the potential to generate returns in excess of the long-term return of equities, private investments are less liquid and therefore, mandate a longer-term horizon. Public investments provide daily liquidity, daily volatility, therefore daily emotions, which is the price of admission of owning equities. We complement our public market exposure with private investments to construct an overall asset allocation that is not solely path dependent on interest rates moving lower and/or stocks moving higher to generate 100% of their returns.

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S&P 500: an index of 500 of the largest U.S. companies and widely recognized as a barometer of the U.S. equity market.

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[i] Thechartstore.com

[ii] The Federal Reserve created MSLF, MSELF, PMCCF, SMCCF, TALF, MLF, PPPLF, MMLF

[iii] 60 minutes interview May 17, 2020

* Fallen Angels: Investment Grade Bonds that were downgraded to junk (if they were investment grade on March 22)

** Student loans, auto loans, credit card loans, etc.

*** The SMCCF may purchase eligible U.S. listed ETFs whose investment objective is to provide broad exposure for U.S. corporate bonds, the preponderance which will be investment grade

[iv] As of May 21, 2020

[v] Continuing claims as of May 2, 2020 who are filing for ongoing weekly benefits

[vi] JPM Asset Management May 2020

[vii] Bloomberg

[viii] Blackrock May 7, 2020