The S&P 500 Declines Are Far from Over As The Fed Drains Liquidity

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S&P 500 Futures (SPX)71 Comments 48 Likes

Summary

- The S&P 500 just fell for the seventh week in a row.
- The S&P 500 is now fairly valued based on the PE ratio.
- However, reserve balances are falling quickly, and that is the biggest problem the market faces.
- Looking for a helping hand in the market? Members of Reading The Markets get exclusive ideas and guidance to navigate any climate.

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The stock market had a rough week, with the S&P 500 (SPX) finishing lower for the seventh straight week and down almost 20% from the intraday peak during the first week of January. The 7-week losing streak for the S&P 500 is the longest since March 2001.

Many people are desperately searching for the bottom or trying to call the bottom in the S&P 500. While we may be closer today than we were in January, the market still has ways to go before this all is said and over, perhaps as much as 15% more.

Multiple Compression to Deleveraging

The market has moved from a period of multiple compression to deleveraging. Unfortunately, the deleveraging process has only started. While the PE ratio and bond yields can be a guide, they don't fully explain what is happening because, if you haven't noticed lately, bond yields have stopped rising, yet stocks keep falling.

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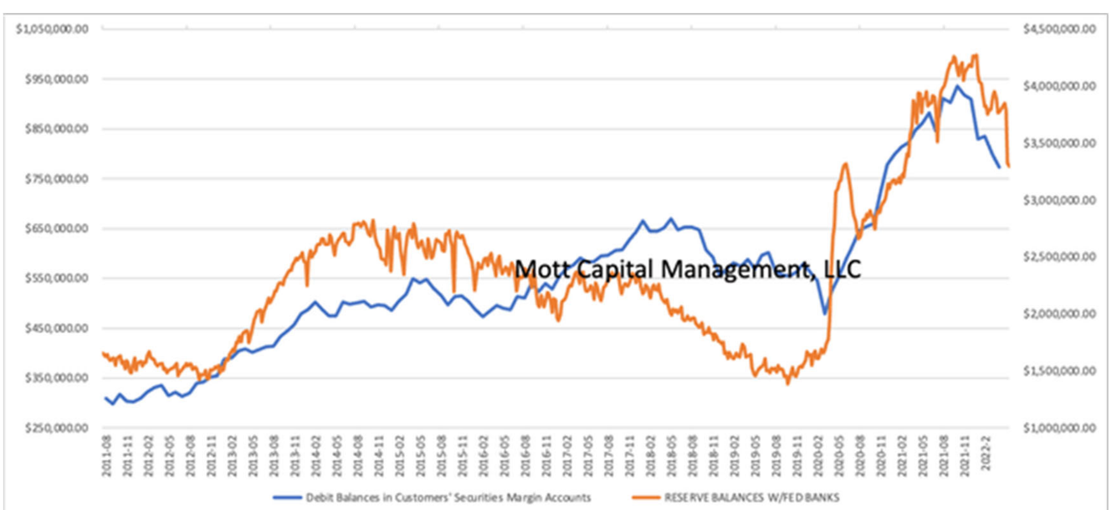
That is because low real yields were only half the story. The other part of the story is the liquidity provided by the Fed, which created the expansion of margin and leverage. Now, reserve balances are declining quickly, and stock prices are deflating along the way.

As the Fed started to conduct QE, it inflated the size of its balance sheet, and as a result, the reserve balance of depository institutions held at the Fed increased. These credits appear to have worked their way into the stock market by increasing margin levels. The chart below shows a clear relationship between FINRA Margin balances and changes in reserve balances over the last decade.



Mott Capital Management

The changes in margin balances, or leverage, were then able to work their way through into the stock market and helped to inflate the value of the S&P 500. We can see the relationship between the two over the years.

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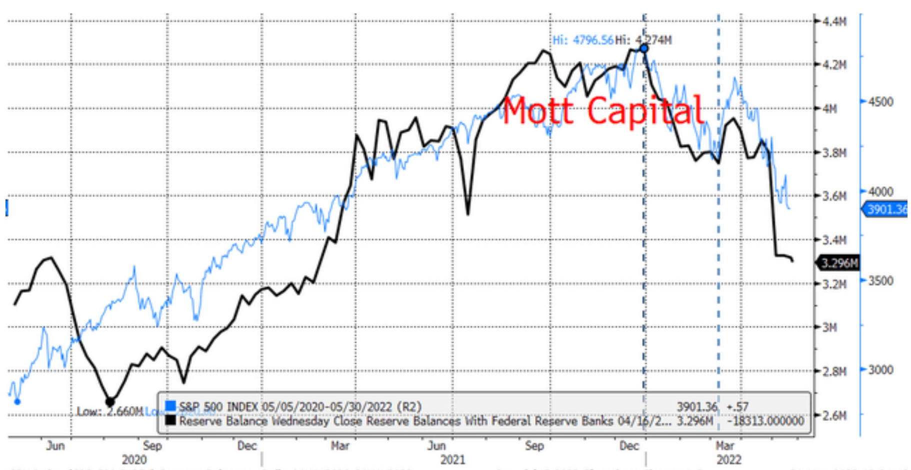
How Far Can the S&P 500 Fall?

What About A Rebound?

So is a bottom nearby? Probably not. Can the market rebound and bounce? It can, but don't expect a big one. The latest data shows that reserve balances have fallen dramatically and continue to push lower as more money gets plowed into the Fed's Reserve Repo facility and the US Treasury's removal of assets from its account. The interesting thing is that the changes in reserve balances are typically not reflected in the stock market for about two weeks. The chart below considers that 2-week offset and shows that reserve balances have plunged, and the decline has been reflected in S&P 500. The data also shows that there may be no significant rebound for stocks, maybe just a small one at best, because the reserve balances have continued to fall.



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Eventually, reserve balances will fall enough that margin levels will normalize, and the market should begin to function normally. But given the size of the balance sheet and how much there is more to go, it may take some while longer for that balance to be reached.