Today's Market

Nobody Will Save You This Time

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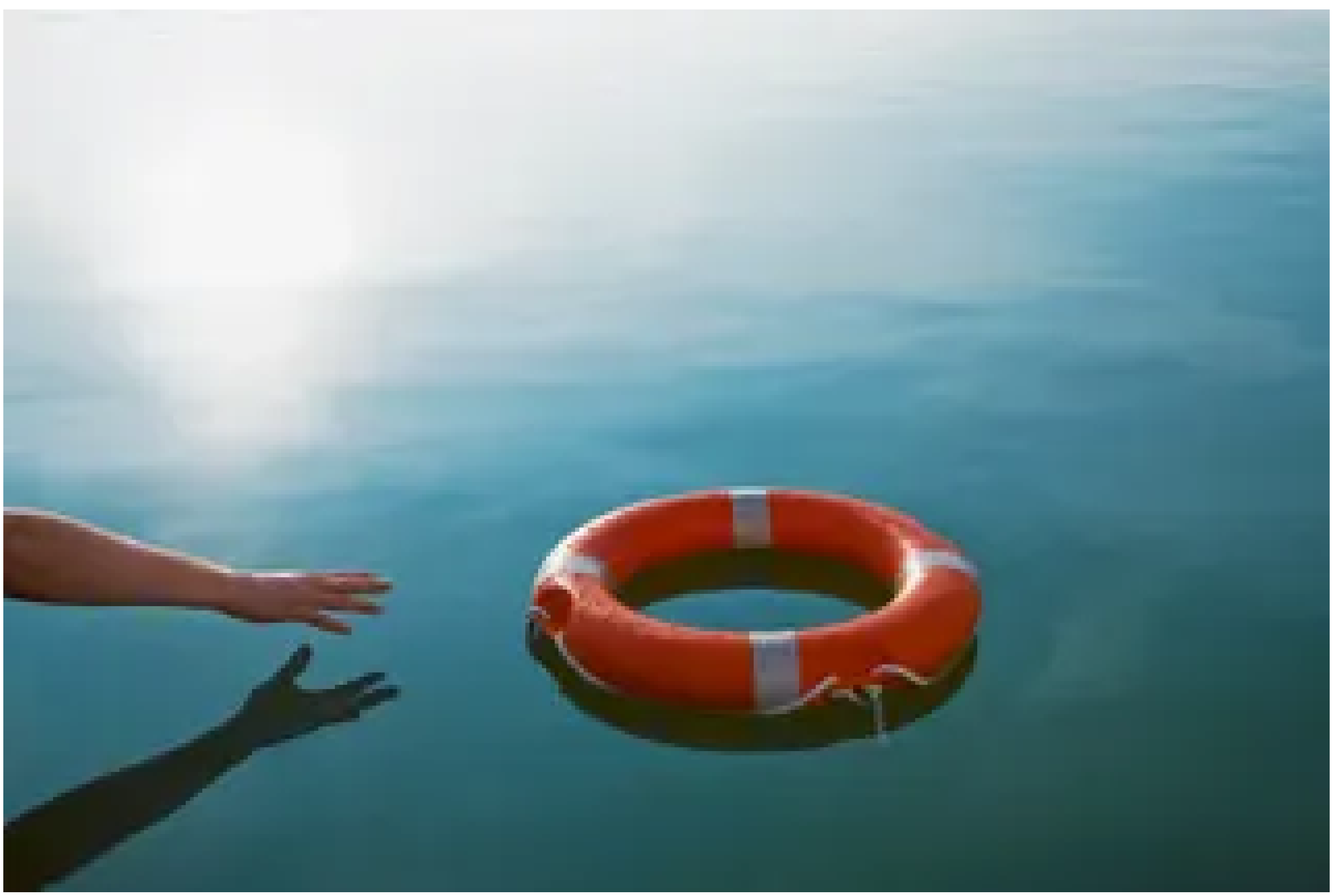
Summary

- Since the GFC, the Fed always came to the market rescue during times of stress.
- Today, the exact opposite is taking place, as the Fed is moving aggressively toward tightening policy.
- Investors should not wait for the Fed to save the markets this time around.
- The time is now to reevaluate portfolio allocations and adjust accordingly with deliberation and care.



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Time to fly

Investors have been conditioned for more than a decade. Since the calming of the Great Financial Crisis (GFC) more than thirteen years ago, we have seen the stock market stumble badly on several occasions. But in each past drop, the U.S. Federal Reserve quickly came running to the rescue with a fresh new deluge of easy monetary support to spark a resurgence in stock prices. Not so this time, however. Stocks have been ailing for months now, but instead of bailing investors out with yet another round of new monetary stimulus to save the day, the exact opposite is happening, as the Fed is increasingly tightening the screws. The implications for stock investors in the months and perhaps years ahead cannot be overstated. And the time to adjust your portfolio strategy in response to this reality is now.

Reflecting on the past to inform our future

To highlight the significance of what is taking place for the stock market today, it is worthwhile to discuss and contrast what we have seen in the past. The time since the GFC has provided us with five different comparable occasions worthy of discussion in this context. Let's begin.

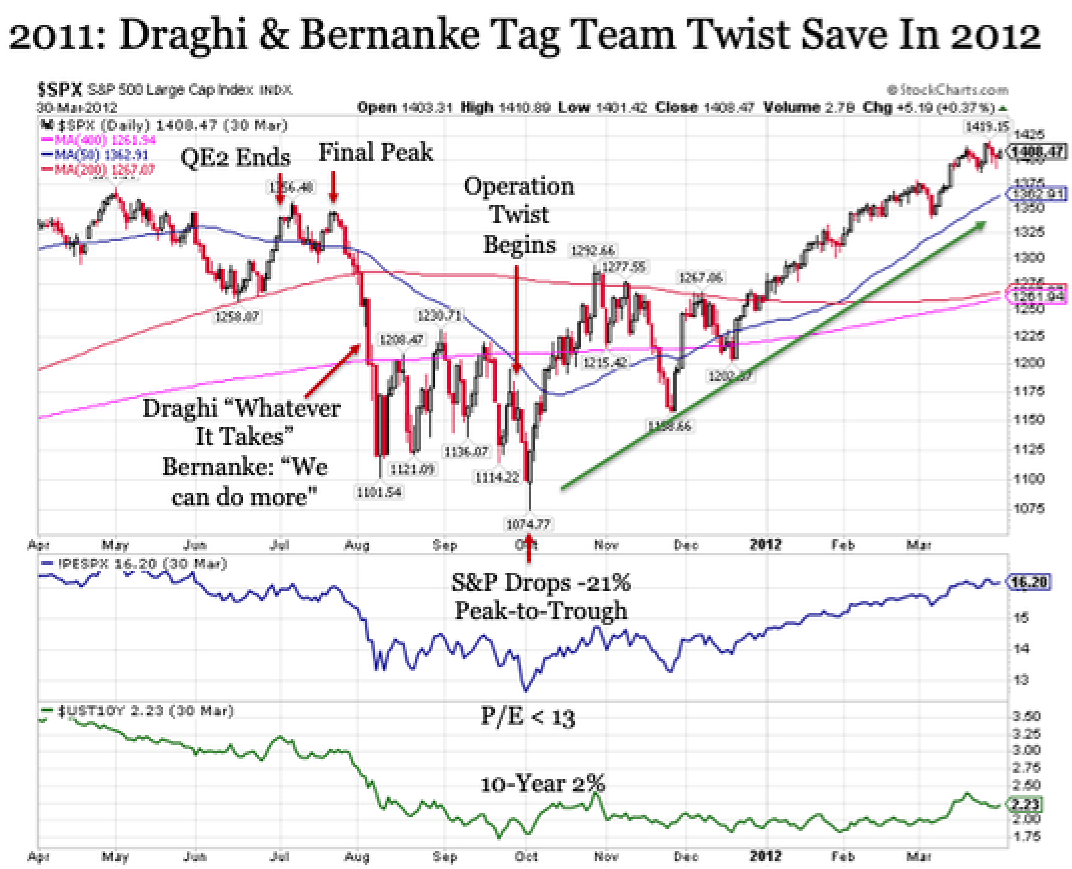
2010 – The End of QE1. In response to the Great Financial Crisis, the U.S. Federal Reserve embarked on what eventually became its first of many rounds of large scale asset purchases that came to be known as Quantitative Easing, or QE. The Fed's first QE program that had commenced in November 2008 was meaningfully expanded on March 18, 2009, which included adding the purchase of $300 billion in U.S. Treasuries (it is no coincidence that the final stock market bottom in the wake of the outbreak of the GFC took place just a few trading days earlier on March 9, 2009). Fed asset purchases continued over the next year before concluding at the end of March 2010, and the U.S. stock market rallied sharply all along the way.

2010: Bernanke With The QE2 Stick Save After QE1 Ends

Source: Gerring Capital Partners, StockCharts.com

While stocks continued to rise for the first few weeks after QE1 ended, trouble quickly followed. After peaking in late April 2010, the S&P 500 subsequently dropped by more than -18% over the next two months through the end of June. Seeing how precipitously the stock market was falling without the support of Fed asset purchases, monetary policy makers started jawboning with supportive words that the Fed could do more to help. And by late August 2010, then Fed Chair Ben Bernanke in Jackson Hole explicitly reassured investors that more monetary easing would soon be on the way. With the market P/E below 15 times and 10-Year U.S. Treasury yields that had dipped to around 2.5%, stocks quickly took off to the upside. And by early November 2010, the Fed delivered on its implied promise with a fresh new $600 billion Treasury asset purchase program in QE2. Stocks continued to rejoice through the first half of 2011.

2011 – The End of QE2 & The European Debt Crisis. The U.S. stock market first peaked at the start of May 2011. And despite a pocket of turbulence into June that year, the S&P 500 was effectively back at its post crisis peak when QE2 came to an end on June 30, 2011. But similar to the immediate aftermath of QE1, stocks continued to rise for a few weeks into July before suddenly cascading to the downside. Accompanying the stock decline was an unfolding debt crisis across at risk European economies including Italy, Greece, and Spain. But with deflation looming as a threat, Fed Chair Bernanke and his European Central Bank counterpart Mario Draghi came out with monetary fire hoses at full blast. By late July, Draghi promised he was "ready to do whatever it takes", while Bernanke also indicated to financial markets that the Fed had the ability to do more.



Source: Gerring Capital Partners, StockCharts.com

Stocks proceeded to grind back and forth for the next two months in falling by -21% peak to trough. But by late September 2011 just after the Fed announced the launch of its latest extraordinary monetary policy incarnation in Operation Twist (the Fed engaged in selling short-term Treasuries and buying the equivalent in long-term Treasuries), stocks endured one final last gasp dip lower through the start of October before subsequently heading off to the races to the upside for the rest of 2011 and into 2012. Market valuations that had fallen below 13 times earnings and a 10-Year Treasury yield that had dropped back below 2% helped support the revival that carried through the next couple of years thanks to the Fed eventually piling on with its largest stimulus plan to date in QE3 that ran from January 2013 to October 2014 and included more than $1.5 trillion in Treasury purchases.

2015-16 – The Oil Crash. By the mid-2010s, the U.S. stock market had put the GFC behind it by breaking out to new all-time highs. But all was still not well underneath the market surface. Although they had finally brought quantitative easing to an end (at least at the time), they struggled with trying to lift short-term interest rates off of the zero bound. And by May 2015, the stock market had peaked amid a growth deceleration in China and a snowballing decline in oil prices. After a jarring stock market flash crash in August, stocks managed to regain their footing and the U.S. Federal Reserve managed to muster out their first quarter point interest rate increase on December 17 of that year.

2016: Yellen Saves With Patience

Source: Gerring Capital Partners, StockCharts.com
Oil prices bottom down 75%

Although stocks managed to hold their ground for a few weeks through December 29, by the time the calendar flipped to 2016, stocks were already picking up steam to the downside. By February 11, stocks had registered a -16% peak-to-trough decline when then Fed Chair Janet Yellen took to the microphone before Congress with prepared testimony designed to soothe stock market nerves. This included warnings about future growth prospects that effectively took the idea of any further rate hikes from the Fed off the table. Monetary policy would remain easy, and although stock valuations had risen above 20 times earnings, a plunging 10-Year Treasury yield toward 1.6% and oil prices that had fallen by nearly 75% provided the disinflationary/deflationary backdrop that ensured investors that the Fed could remain easy for as long as needed and still do more to provide monetary support if needed. No sooner did Yellen speak and the race back to the upside was on.

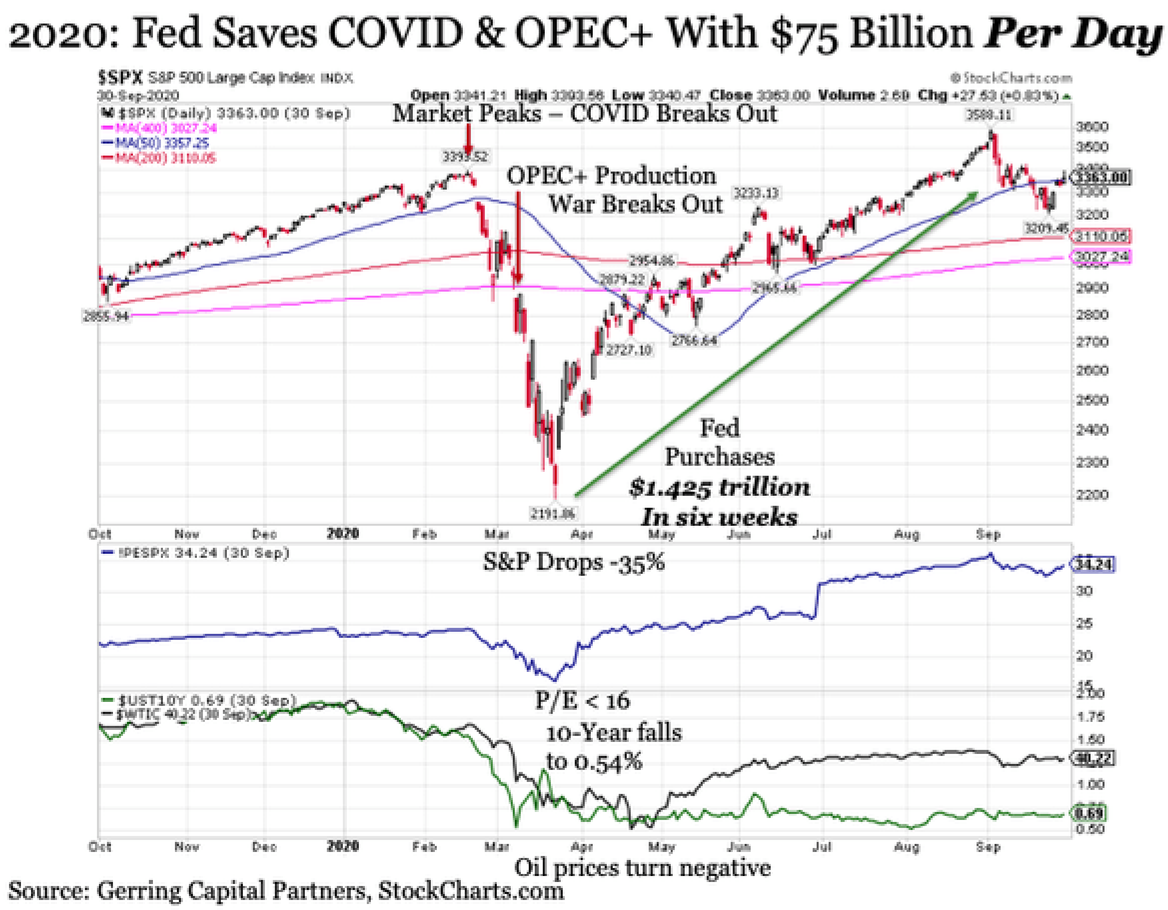
2018-19 – Q4 Capital Market Plunge. Although non-U.S. stocks effectively peaked at the start of 2018, U.S. stocks continued their climb for the first three quarters of the year. These gains were taking place alongside the Fed carrying out seven quarter point rate increases dating back to December 2016. But no sooner did the fourth quarter of 2018 get underway and stocks started cascading to the downside. This stock decline was taking place despite the lack of any meaningful deterioration in economic conditions. In short, it had the look of a market that was letting off some long overdue froth with stock valuations at 24 times earnings and a 10-Year U.S. Treasury hovering near 3.25%, thus a very tight equity risk premium. The Fed initially showed policy making discipline by carrying out another quarter point rate hike on December 20 in recognition of the still steadily performing economy. But after a further -4% drop on the S&P 500 over the next two trading days, suddenly this monetary policy discipline went completely out the window.

2018-2019: Powell Saves With A Dramatic About Face

Source: Gerring Capital Partners, StockCharts.com

By Christmas Eve 2018, the S&P 500 had fallen by -20% peak to trough. And what had been further rate hikes and a balance sheet reduction program on autopilot just a couple of days earlier suddenly began turning a complete opposite direction. I could editorialize all day long about what took place these final days of 2018, but the fact of the matter remains that by the time the calendar turned to 2019, the full-fledged monetary policy flip flop was officially underway. The Fed had the flexibility to completely reverse course given the disinflationary/deflationary backdrop given that 10-Year Treasury yields had dropped by 80 basis points and oil prices had also plunged by 45%. And stocks quickly rebounded sharply to the upside through the first half of 2019.

2020 – COVID. Everything seemed to be humming along fine for the U.S. stock market through late February 2020. Although the yield curve had inverted back in August 2019 and signs of a dragging economy were accumulating, the S&P 500 was setting successive new all-time highs for months. But once the news broke that COVID cases were spreading rapidly outside of China, global capital market liquidity quickly started seizing. Stocks had dropped by -16% peak-to-trough, and the Fed was already intervening aggressively to support the economy and financial markets by the end of February. Stocks were even showing resilience with a strong bounce in the first week of March. But what is now the largely forgotten second knockout punch to global capital markets at the time, Russia and Saudi Arabia over the weekend of March 7-8 launched into an OPEC+ price war. This not only sent global stocks including the S&P 500 reeling to the downside, but it also sparked crippling volatility in the bond, commodities, and precious metals markets. By March 23, the U.S. stock market had fallen by -35%.



With a full-fledged deflationary spiral starting to unfold including the 10-Year Treasury yield tumbling toward the zero bound and oil prices briefly turning negative, the Federal Reserve held nothing back in the monetary policy arsenal. This included the launch of the latest QE program that made any prior incarnation seem miniscule by comparison. For example, it took the Fed more than a year to deploy $300 billion in Treasury purchases as part of QE1. In response to COVID, the Fed purchased $300 billion in Treasuries in just *three days*. It took the Fed nearly eight months to carry out $600 billion in Treasury purchases as part of QE2. During the COVID outbreak, the Fed made $600 billion in Treasury purchases in *six days*. And it took the Fed 22 months to carry out $1.5 trillion in Treasury purchases as part of QE3, which until COVID was considered the epic QE program. But during COVID, they matched this $1.5 trillion in Treasury purchases in just over a month. And then they continued gobbling up Treasuries at a rate of $80 billion per month, or nearly $1 trillion a year, for the next year and a half through late 2021 before *FINALLY* starting to wind the program down. And they kept going despite the fact that the U.S. stock market had soared to new peaks more than 50% above previous highs and the U.S. economy had reopened with several consecutive quarters of explosive GDP growth.

Stark contrast

All of this brings us to today. Since the calming of the GFC, we have had five previous major episodes where the S&P 500 dropped by -15% or more. Each of these past price drops were accompanied by definite disinflationary/deflationary signals including sharply declining bond yields and/or commodities prices. This afforded global monetary policy makers complete and total flexibility to react almost immediately if not reflexively with a massive and dramatically supportive response. Each time this sent U.S. stocks almost instantaneously sharply rebounding back to the upside.

Unfortunately for investors, that’s not at all what we have converging across financial markets today.

2022 – Inflation and Ukraine. Since the second trading day of 2022, U.S. stocks have been moving steadily to the downside. This includes a -15% peak-to-trough decline in the S&P 500 and an even more pronounced -22% drop in the tech heavy NASDAQ Composite Index dating back to just before Thanksgiving. But in total contrast to the five past episodes highlighted above, these declines have come with the backdrop, if not the result of, rapidly escalating inflationary pressures. This has included 10-Year Treasury yields rising back above 2% and oil prices spiking above $100 a barrel.

2022: S&P Down -15%, Fed Ends QE & Raises Rates

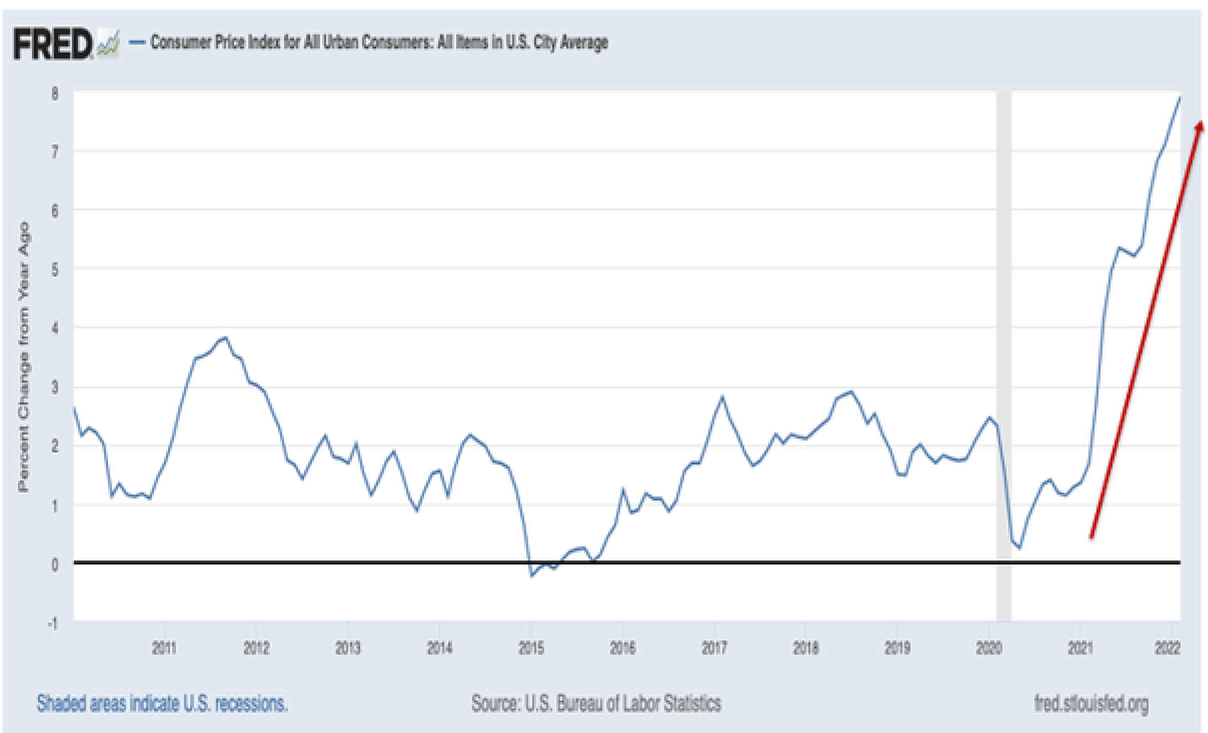
Source: Gerring Capital Partners, StockCharts.com

During each of the past five episodes, the Federal Reserve would have been scurrying to the market rescue with major monetary support to save the day. But the absolute exact opposite is happening today. Instead, the Federal Reserve not only closed up shop with its final COVID related QE asset purchases on March 9, but it moved a few days later to raise interest rates by a quarter point for the first time since late 2018. And when announcing this first rate hike, the Fed suggested to the market that it should expect at least six more quarter point hikes through the remainder of the year. Making matters worse, signs are also starting to accumulate suggesting that an economic recession is becoming an ever greater probability as soon as toward the end of this year. Looming stagflation anyone? A word for stock market investors: OUCH!

Bottom line

Here's the thing. Stocks have already fallen by as much as -15% in recent months. But unlike the last five times since GFC, the monetary policy support and liquidity that helped spark the major stock market rebounds to the upside is not only gone, but the Fed is only now just getting started with taking an increasing amount of liquidity away. Despite what stocks may have done last week in the immediate aftermath of the Fed announcement, they are very unlikely to like this shift in the liquidity tides very much at all as we continue forward into the spring and summer. This is particularly true with stocks already trading at a frothy 25 times earnings. And if it turns out that either inflation remains persistently high and/or Treasury yields continue to rise and/or the economy slows into recession, then investors should brace for an even more pronounced downside move in stocks as we continue forward.

Inflation Must First Be Tamed Before The Markets Can Be Saved



Source: Gerring Capital Partners, U.S. Bureau of Labor Statistics, St. Louis FRED

But won't the Fed reverse course on tightening monetary policy if the decline in stocks gets bad enough? This is certainly possible, as I'll be the first to reiterate that what the Fed promises is not necessarily what they deliver, particularly when it comes to monetary tightening. But here's the reality. They aren't reversing course on anything until they definitively get inflationary pressures under control. This means that the Fed is likely to be heavily biased toward tightening monetary policy aggressively at least for the next few months if not longer, as the 1970s and early 1980s taught the Fed that an outbreak of high inflation must be completely snuffed out before attention can turn back to supporting economic growth and/or asset prices. Sure, the Fed might eventually come to the rescue, but what damage will stocks have sustained by the time they are ready and able to do so? At 25 times earnings with sharply rising input costs and potentially slowing economic growth, the potential downside damage could end up being profound before it is all said and done. Thus, it will be critically important to monitor market developments closely in the days, weeks, and months ahead.

What to do and not do?

First and foremost, investors must maintain discipline and move deliberately with any potential portfolio changes. While I typically preach making portfolio adjustments at the margins (in other words, small changes to a broader asset allocation at any given point in time), even the moments where larger shifts in portfolio strategy may be warranted should be carried out gradually and in stages to protect return expectations and maintain risk control (both upside and downside risk) objectives. I have measurably reduced equity weightings and raised cash allocations in recent months, but at the same time, I remain meaningfully invested in accordance with my broad asset allocation strategy objectives.

It is also important to note that within equity allocations, I continue to emphasize those areas of the stock market that have the potential to continue to perform well even if the broader S&P 500 continues to decline. This includes an overweight to the energy, metals, defense, pharmaceutical, and banking industries with a particular focus on stocks with discounted absolute and relative valuations. I am also emphasizing non-U.S. country allocations such as the United Kingdom, Switzerland, Singapore, and New Zealand that are more concentrated in stock market segments with these similar characteristics.

Beyond stocks, I remain fully allocated in my asset allocation models to long-term U.S. Treasuries, TIPS, and long-term TIPS. I also continue to maintain a full model allocation to gold.

Of course, all of these allocations are subject to change depending on how market conditions and events unfold from here.

Now is not the time for complacency

We are only now just entering a stock market environment we have arguably not experienced in more than four decades. And history has not been kind to stocks under such conditions in the past - recall during the stagflationary 1970s that stocks fell by more than half on an inflation adjusted basis, with the decline being driven by both weakness in real earnings growth, but also a meaningful compression in valuations. While conditions may ultimately change and relief could eventually be in order for stock investors, waiting for the Fed to save the stock market day like they have so many times in the past is no longer a prudent strategy. Now is the time for investors to reevaluate, which includes an assessment of how much downside can be tolerated and what adjustments may be necessary to protect oneself in a market where the tide is already heading out and may not be coming back in anytime soon.

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