RIA Advice

Fed Kills The Bear...For Now

The full newsletter will return next week.

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It's 4:40am on Friday morning and I am sitting in the airport waiting for my flight to Vancouver, B.C.&#2013266080; One thing about being at the airport this early...there is no line...for anything.&#2013266080; Anyway, I am on my way to present at the annual MoneyTalk Conference where I am honored to be the keynote speaker this year.&#2013266080;

But here is my problem. I had to prepare my presentation and send it to my hosts a couple of weeks ago. The topic was simple enough...*"how to navigate a market that has changed trend."*

The problem, for my presentation on Saturday anyway, is&#2013266080;that narrative may have been postponed. Which is what I want to discuss with you this week - *"How the Fed sent the bears back into hibernation...for now."&#2013266080;*

(When I get back next week I will post the entire presentation deck for you.)

First, let's start with what happened last week as we discussed in a post for our RIA PRO subscribers:

> *"The statement and press conference following the January 30th&#2013266080;Federal Reserve policy meeting was, **with little doubt, a further pivot to a dovish stance.** The statement below is from the prior December meeting and marked up in red to highlight changes in the current January 30th statement. The big clue about future interest rate policy is in the following addition:&#2013266080; 'the Fed will be patient as it determines what future adjustments to the target range?' **'Patient' tells us that the Fed?s plans to raise rates two or three times in 2019 are now on hold. It also leads the reader to believe the next move could just as easily be a reduction in rates."***

Information received since the Federal Open Market Committee met in ~~November~~December indicates that the labor market has continued to strengthen and that economic activity has been rising at a ~~strong~~solid rate. Job gains have been strong, on average, in recent months, and the unemployment rate has remained low. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier ~~in the~~last year. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. ~~Indicators~~Although market-based measures of inflation compensation have moved lower in recent months, survey-based measures of longer-term inflation expectations are little changed~~, on balance~~.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. ~~The~~In support of these goals, the Committee ~~judges that some further gradual increases in~~decided to maintain the target range for the federal funds rate ~~will be consistent with~~at 2-1/4 to 2-1/2 percent. The Committee continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective ~~over~~as the ~~medium term. The Committee judges that risks to the economic outlook are roughly balanced, but will continue to monitor~~most likely outcomes. In light of global economic and financial developments and ~~assess their implications~~muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the ~~economic outlook~~federal funds rate may be appropriate to support these outcomes.

~~In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 2 1/4 to 2 1/2 percent.~~

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its maximum employment objective and its symmetric 2 percent inflation objective. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

Voting for the FOMC monetary policy action were: Jerome H. Powell, Chairman; John C. Williams, Vice Chairman; ~~Thomas I. Barkin; Raphael W. Bostic;~~ Michelle W. Bowman; Lael Brainard; James Bullard; Richard H. Clarida; ~~Mary C. Daly; Loretta J. Mester; and~~ Charles L. Evans; Esther L. George; Randal K. Quarles~~.~~; and Eric S. Rosengren.

*"The next important takeaway came in regards to the Feds balance sheet. In the press conference Jerome Powell, as he has done recently, alluded to the idea that QT is not on '**autopilot'**&#2013266080;anymore. **In other words, it is likely the Fed will not continue to reduce the pace at which they are shrinking their balance sheet without considering the economy and financial markets.** We stress the word 'autopilot' because that was how Jerome Powell to described the pace of balance sheet reductions at the December 19, 2018 FOMC meeting press conference. The ensuing market mayhem in the days following the press conference appears to have rattled the Fed into modifying that take quite substantially. **In fact, they have done a 180-degree reversal in only six weeks."***

Image not found or type unknown

And just like that, the *'Fed Put"* was back.&#2013266080;

2018 was a year where the markets had begun to adjust for tighter monetary policy. Jerome Powell was believed to be different from his predecessors by focusing more on economic stability and the avoidance of asset bubbles rather than being driven by the whims of the financial markets.

It only took a 4.4% decline in the S&P 500 last year, combined with strong comments from the White House and no doubt strong pressure from the Fed's member banks, to make Mr. Powell the&#2013266080;*"market's b*tch"*

But what is most important was the release of the&#2013266080;supplementary statement entitled "*Monetary Implementation and Balance Sheet Normalization"*&#2013266080;in conjunction with the FOMC statement. **The bullet point below from the statement makes it clear that&#2013266080;<u>increases</u>&#2013266080;to the balance sheet, also known as QE, will be a part of their tool kit going forward.**

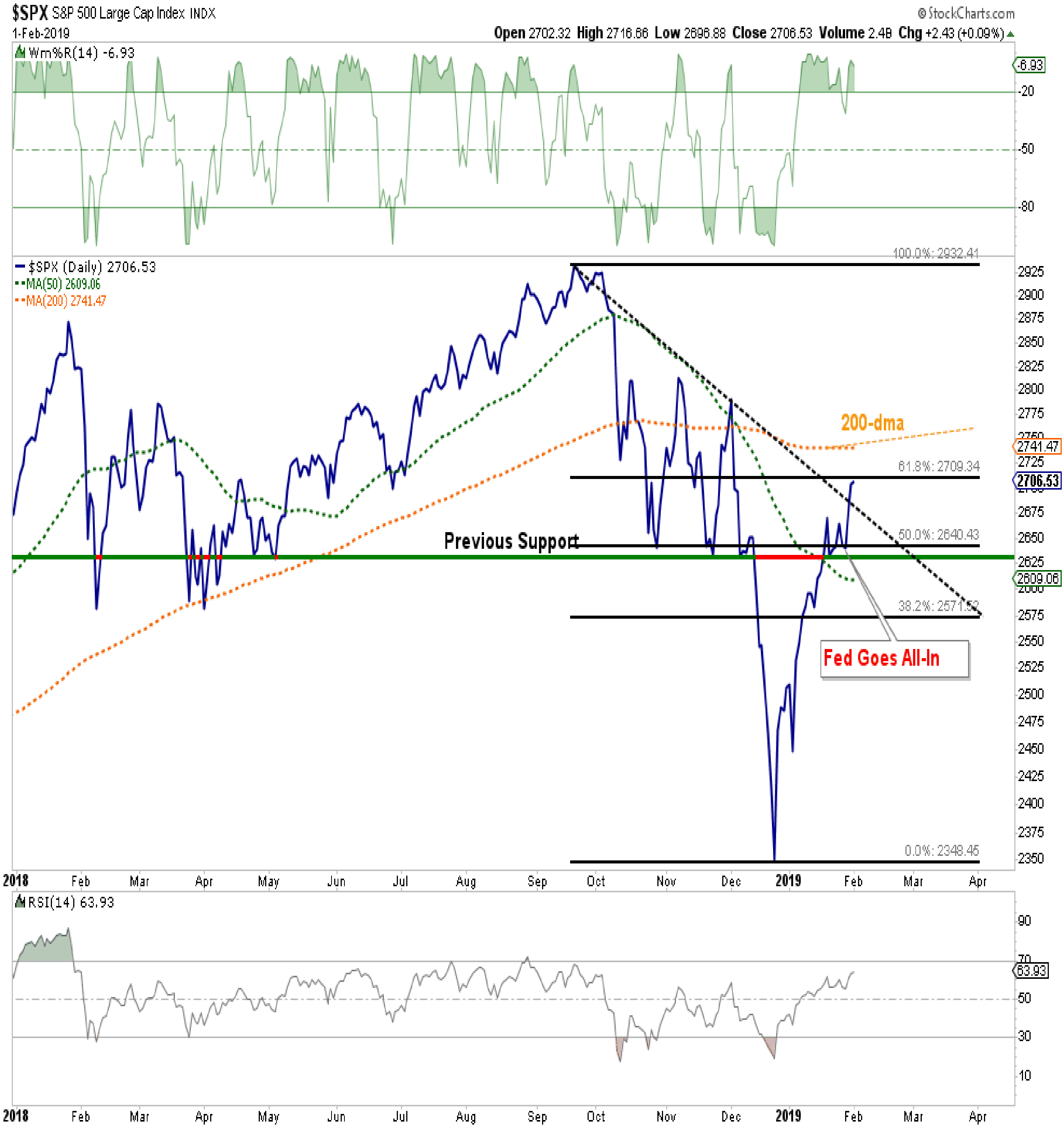
As Mike Lebowitz noted last week:

> *"This is curious as Powell was adamant that QE two and three should not have been executed after the financial crisis abated.&#2013266080;**Now, without much reason, the specter of QE is being raised."***

- The Committee continues to view changes in the target range for the federal funds rate as its primary means of adjusting the stance of monetary policy. The Committee is prepared to adjust any of the details for completing balance sheet normalization in light of economic and financial developments. Moreover, the Committee would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate.

> *"In our opinion, the Fed?s new warm and cuddly tone is all about supporting the stock market. The market fell nearly 20% from record highs in the fourth quarter and fear set in. There is no doubt President Trump?s tweets along with strong advisement from the shareholders of the Fed, the large banks, certainly played an influential role in persuading Powell to pivot."*

As our headline this week denotes - the shift in policy has temporarily put the bulls back into hibernation. As the chart below shows, the market not only broke out of its recent consolidation and successful retests of the 50-dma but also broke the downtrend line from the 2018 highs.&#2013266080;



Currently, the next major resistance level will be the 200-dma which is just ahead along with the cluster of tops of the consolidation range in October and November of last year.&#2013266080;

But, with the Fed now back to providing plenty of *"accommodation"* to the markets, even if it is only verbal at the moment, there is a bias to the upside for the markets currently. As shown below, the last time we got a short-term *"buy"* signal, like the one triggered just one week ago, it led to the rally that the markets to new all-time highs.

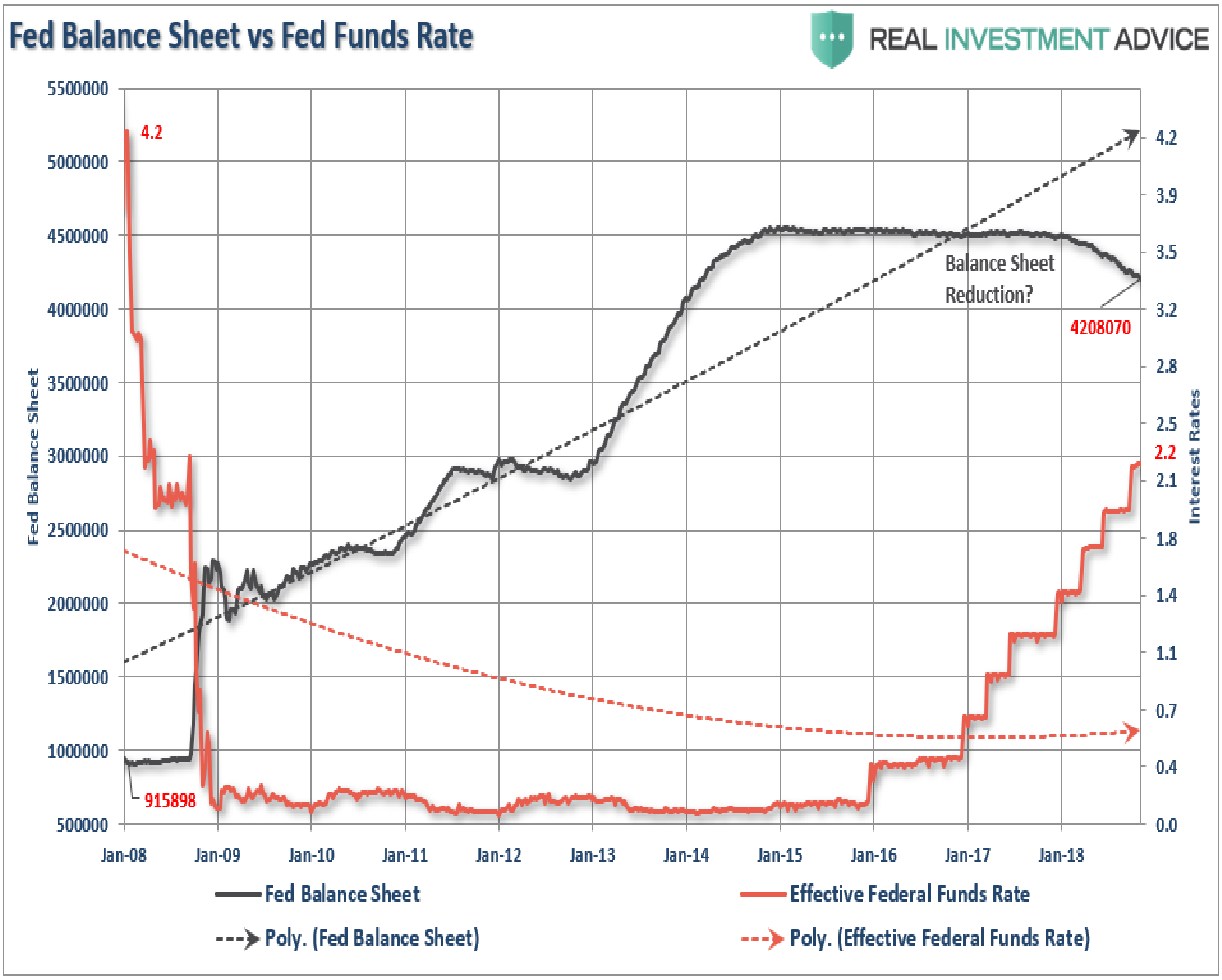
As I noted two weeks ago in this missive, these were all of the ingredients necessary to bring the [bear market that began in 2018](#) to its end.

For now.

The Fed Is Limited

While the Fed certainly gave the markets what it wanted in the near-term,&#2013266080; in the longer-term there is actually very little the Fed will be able to do to stem the next recessionary bear market.&#2013266080;

The chart below shows why.&#2013266080;



In 2008, when the Fed launched into their&#2013266080;*?accommodative policy?*&#2013266080;emergency strategy to bail out the financial markets, the Fed?s balance sheet was only about $915 Billion. The Fed Funds rate was at 4.2%.

If the market fell into a recession tomorrow, the Fed would be starting with roughly a&#2013266080;**$4 Trillion**&#2013266080;dollar balance sheet with interest rates 2% lower than they were in 2009.&#2013266080;In other words, the ability of the Fed to&#2013266080;*?bail out?*&#2013266080;the markets today, is much more limited than it was in 2008.

> *"So what? There are plenty of bonds to buy."*

True, but there are other factors at play which will also dramatically limit the effectiveness of further rounds of accommodation.&#2013266080;

When the Fed launched QE in 2009, market valuations had been reverted to below the long-term average and investor sentiment had been completely washed out. The massive selling that occurred as the markets collapsed left a huge amount of "pent up" demand for equities.&#2013266080;

Today, that is no longer the case.&#2013266080;

Valuations are no longer cheap by historical standards, but instead are expensive by virtually every measure.&#2013266080;

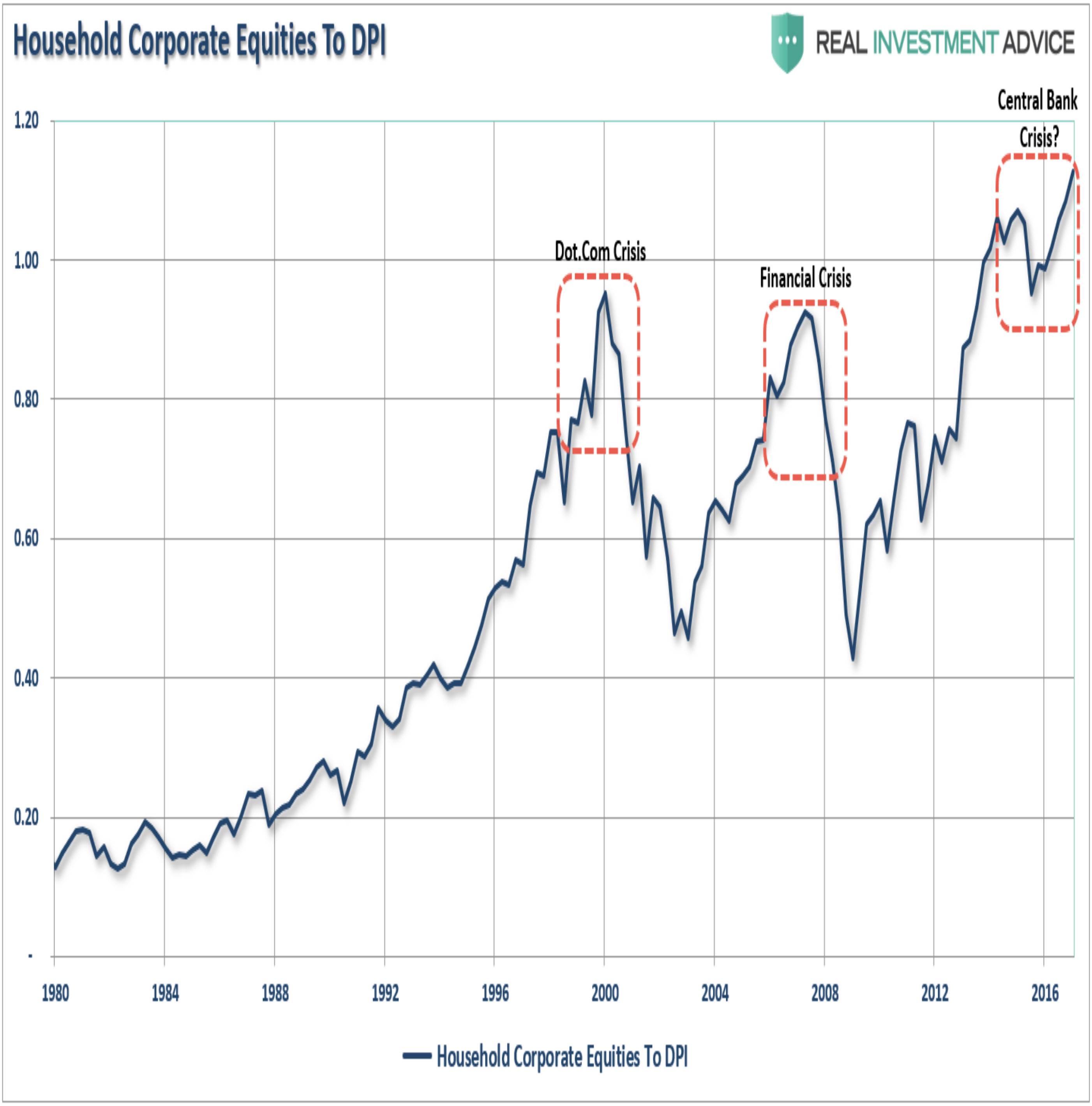
As&#2013266080;Goldman Sachs&#2013266080;pointed out recently, the market is pushing the 89% percentile or higher in 6 out of 7 valuation metrics.

Exhibit 4: S&P 500 is expensive on most metrics, but fairly valued on FCF
as of September 13, 2018; data since 1990 for CFO and FCF, 1976 for all others

	Aggregate Index		Median Stock	
Metric (Aggregate index)	Current	Historical %ile	Current	Historical %ile
EV / Sales	2.4 x	97 %	2.9 x	99 %
Cyclically adjusted P/E (CAPE)	28.6 x	90	NA	NA
EV / EBITDA	12.1 x	90	12.3 x	97
Price / Book	3.5 x	89	3.5 x	100
Cash flow yield (CFO)	**6.9 %**	**89**	**6.9 %**	**97**
Forward P/E	17.1 x	84	17.4 x	89
Free cash flow yield (FCF)	**4.0 %**	**56**	**4.0 %**	**56**
Median		**89 %**		**97 %**

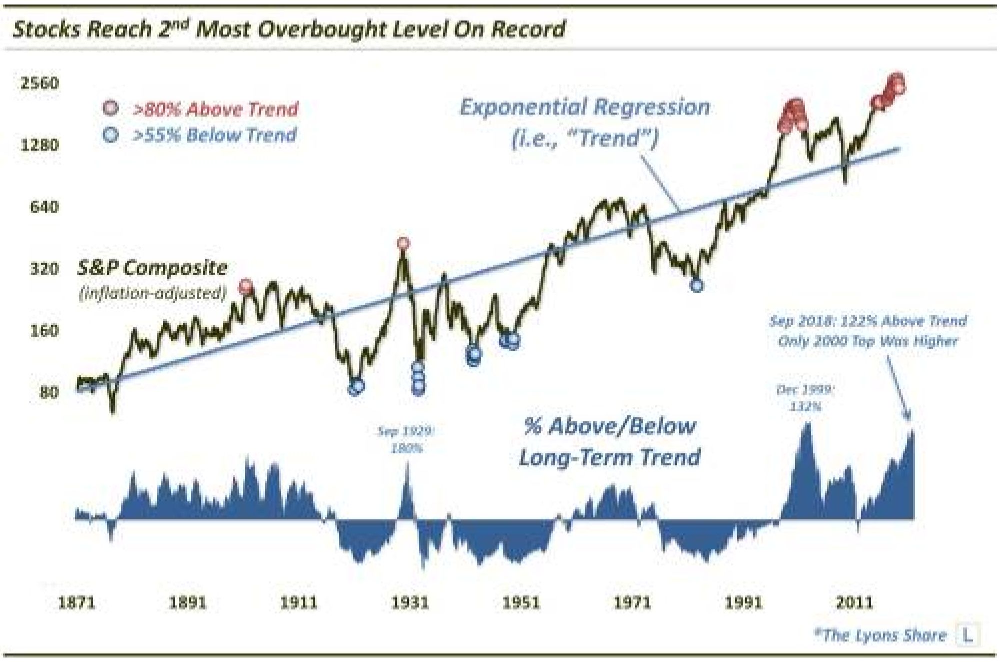
Source: Compustat, FactSet, Goldman Sachs Global Investment Research

There is no longer a "pent up" demand for equity ownership as households now have more equity exposure than at any other point in history.



Furthermore, the market is not grossly oversold and deviated well below long-term trends as it was in 2008. As Dana Lyons recently penned:

> *"We used exponential regression smoothing to find the 'best fit' trend line on the [Shiller data] series from 1871 (h/t to Doug Short for the concept.)*
>
> *After finding the best fit trend line for the composite, we can measure how far above or below prices are at a given time. As it turns out, this past September saw the composite reach 122% above the trend line, i.e., it was 122% ?overbought?. In nearly 150 years, the only months that saw prices more overbought than that were those encompassing the 1999-2000 market top ? the most excessive, bubbly top in U.S. market history."*



While markets can certainly remain extended for much longer than logic would predict, they can not, and ultimately will not, stay overly extended indefinitely.&#2013266080;

The important point here is simply this. While the Fed may have curtailed the 2018 bear market temporarily, the environment today is vastly different than it was in 2008-2009.&#2013266080; Here are a few more differences:

- *Unemployment is 4%, not 10+%*
- *Jobless claims are at historic lows, rather than historic highs.*
- *Consumer confidence is optimistic, not pessimistic.*
- *Corporate debt is a record levels and the quality of that debt has deteriorated.*
- *The government is already running a $1 trillion deficit in an expansion not half that rate as prior to the last recession.*
- *The economy is extremely long is a growth cycle, not emerging from a recession.*
- *Pent up demand for houses, cars, and other durables has been absorbed*
- *Production and Services measures recently peaked, not bottomed.*

In other words, the world is exactly the opposite of what it was when the Fed launched *"monetary accommodation"* previously. Logic suggests that such an environment will make further interventions by the Fed less effective.

The only question is how long will it take the markets to figure it out?

Bull In A Bear's Den

Michael Lebowitz and I recently discussed the market in a broader sense for our subscribers at RIA PRO.&#2013266080;

There is the announcement for my flight.

See you next week.&#2013266080;

The Full Newsletter Will Return Next Week