Weekly Market Flash

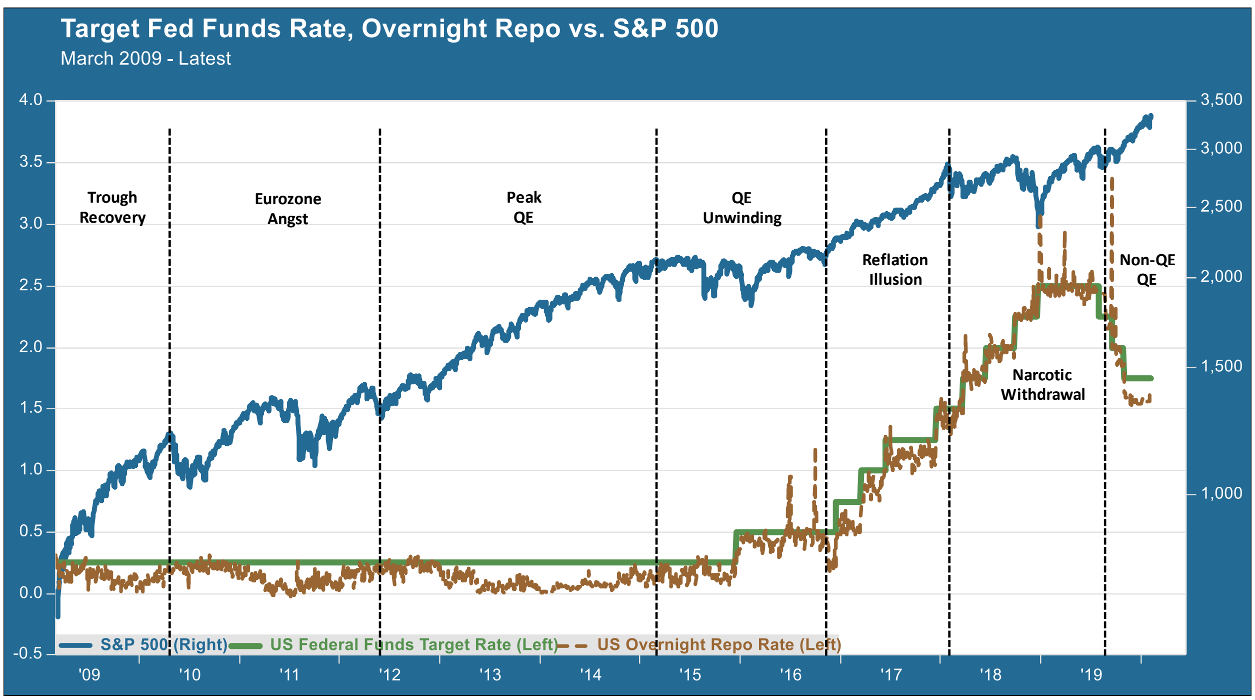
Bull Story, Chapter Seven

February 7, 2020

All happy families are alike, said the great Russian author Tolstoy in the opening lines of “Anna Karenina,” but the same does not apply to happy stock market rallies. The bulls are as different from each other as their unhappy ursine counterparts. The Great Bull of the 2010s will – in the absence of an unseen X-factor blowing things up in the meantime (reminder: this is a non-zero probability) – reach its eleventh anniversary in March of this year (that will still not match the all-time record of December 1987 – March 2000). It’s a good time to step back and take a broader look at the story of this decade, a story made unique by the starring role of one protagonist: the Federal Reserve.

From Unconventional To Ho-Hum Normal

In the chart below we have divided the story of the 2010s bull into seven chapters, each with its own heading and its own particular story.



Source: MVF Research, FactSet

The 2010s bull story began, as most do, with a trough recovery. The Fed had brought the target Fed funds rate (green line) down to a range of zero – 0.25 percent. At the same time the central bank was experimenting with the unconventional policy of purchasing longer-dated fixed income securities that would come to be known as QE. But world events intruded in 2010 and 2011 as a nasty backlash from the financial crisis hit the Eurozone. For most of this time markets were highly volatile. The bull market came very close to running out of steam in August 2011 when it ran into a vortex of the Eurozone, Congressional fumbling of debt ceiling negotiations and a downgrade by Standard & Poors of US Treasury securities.

The Eurozone crisis peaked in June 2012 when European Central Bank chief Mario Draghi talked down jittery markets with his “whatever it takes” speech. Shortly thereafter US Fed chair Bernanke signaled a new wave of easy money that would become known as QE3. Markets rallied strongly with the S&P 500 soaring to its best year since the Roaring Nineties in 2013.

Economy, What Economy?

What has been missing from this narrative so far is any kind of a leading role for the actual economy of real goods and services. Year-on-year GDP growth throughout this period meandered along in the range of two percent, while inflation remained below central bank targets and jobs came back steadily and without interruption, month after month. Outside the US, though, economic trends were not particularly comforting. Europe stabilized but at barely-positive growth levels. China went through a bout of uncertainty that popped a bubble in its own domestic stock market and forced a currency revaluation that caught global markets by surprise in 2015. Meanwhile the Fed had wound down QE3 by the end of 2014 and was signaling its intention to start raising interest rates. US equities seemed to be going nowhere from late 2014 through the contentious election season of summer and fall 2016.

The Reflation That Never Was

That election brought with it the beginning of Chapter 5 in our bull saga. Almost immediately after the Republicans’ seizure of executive and legislative branch control a conviction set in that a massive public infrastructure program was going to send inflation and interest rates soaring. The infrastructure program never happened, as anyone passingly familiar with the priorities of Republican policymaking could have foreseen. But the reflation trade moved ahead on its own momentum for more than a year.

The Stand-Alone Economy That Never Was

Now, though, economic data came back into sharper focus. The Fed was trying to get rates back to some semblance of “normal,” but was a low-growth economy ready to take off the training wheels for once and all? It seemed that in September 2018 markets finally got the memo that the Fed was serious in its quest for an economy able to resemble something close to the norms of the past 50-odd years. Risk assets went into a tailspin, and once again US stocks threatened to bring the bull story to an abrupt end, coming within a hair’s breadth in December of that year. That would also mark the last time there would be serious talk in mainstream financial circles about a self-sufficient economy able to function without the narcotic of easy money.

You Just Keep Me Hanging On

And that brings us to chapter seven. It is admittedly a bit arbitrary to pin a specific date on the beginnings and ends of these chapters, but a likely one for this current installment is September of last year. Late that month the interest rate for overnight repurchase agreements (the brown dotted line in the above chart) suddenly spiked up out of nowhere, setting off alarms about unusually low levels of reserves in the central bank accounts of US banks.

Up to that point, 2019 had been a fairly volatile year for equities. The big rally early in the year was less impressive when seen in juxtaposition to the big correction of late 2018. Several times during the year we witnessed pullbacks of more than five percent. Yes, the Fed was guiding towards a resumption of interest rate cuts, but was that going to be enough? Meanwhile the financial chattering class seemed to be talking itself into a recession, perhaps brought about by the US-China trade war or perhaps just an organic end to what was already the longest growth cycle on record.

The hiccup in the repo market on September 26 caused a few days of jittery trading. But on October 11 the Fed announced that it would step in with a new program of monthly purchases of short-dated Treasury bills in quantities of $60 billion per month. Markets immediately jumped on the news, visions of recession disappeared from investors' eyes and the S&P 500 threw a bang-up holiday party. The index has registered gains of 13.8 percent since that Fed announcement, just four short months ago.

The Fed took pains at the time of this announcement to emphasize it was not starting another QE program. Fed officials have continued to push this line ever since. But the reason it keeps trying to hammer home the point that this is not QE4 is because the market keeps insisting that it is, in fact, QE4. Looks like QE, quacks like QE, must be QE. The Fed's balance sheet is expanding by $60 billion a month, after never having gotten back down to anywhere near its modest pre-2008 levels. QE by any name, right?

Now, this QE-not-QE policy is not the only plot line to our chapter seven. US economic numbers continue to suggest more of the same modest growth trends, while remaining solidly ahead of the plodding Eurozone and never-quite-healthy Japan. China's growth headwinds got much stiffer in the past couple weeks with the coronavirus outbreak. There are plausibly enough reasons out there to keep investors from massively selling off. But the pace of this phase of the bull run is torrid – if it were to last for the duration of the year then it would outpace even last year's gains. For the record, we do not think that is a likely outcome. But momentum can be a tough nut to dislodge, particularly if a melt-up mentality if fully baked into the cake.

The Fed has said it plans to keep its "not-QE" policy in place at least through April, with plans to unwind it as soon as practicable thereafter. But Fed officials should know by now how hard it is to get the market off the morphine of easy money. It will be interesting to see how this dialogue plays out between the doctors and their very needy patients.

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