Don't Fight the Fed

As fans of the Broadway smash hit Hamilton have come to know, Alexander Hamilton proposed the creation of a national bank. In December of 1790, Hamilton submitted a report to Congress in which he outlined his proposal. After much debate, Hamilton's bill cleared both the House and the Senate, and was signed into law by President Washington in February, 1791 (much to Thomas Jefferson's chagrin). The Bank of the United States was formed. This bank is considered by many to be the forerunner of the modern U.S. central bank, the Federal Reserve (aka "the Fed"), which was created by the Federal Reserve Act of 1913.

The Federal Reserve was created by Congress to provide the nation with a safer, more flexible, and more stable monetary and financial system. The Fed conducts the nation's monetary policy, supervises and regulates banks, and maintains the stability and liquidity of the nation's financial system. It does so by managing short term interest rates, by setting bank reserve requirements, and by "open market operations" – the buying and selling of government, and more recently, private securities.

In the year since the coronavirus pandemic began, the U.S. Treasury and the Federal Reserve have provided a great deal of support for the struggling U.S. economy. To provide liquidity and build confidence in markets, the Fed purchased government and private fixed income securities, increasing the size of its balance sheet from $4.167 trillion to $7.411 trillion.[1] On the legislative side, our government has passed four stimulus bills during this period, totaling approximately $3.3 trillion.[2] In addition, a fifth stimulus package is in the works, and if passed in its current form, the cost would be approximately $1.9 trillion.

Assuming the passage of this $1.9 trillion dollar package, the sum total of stimulus provided to our economy over the past year is well over $8 trillion. That's a big number, but how big? For starters, consider that the Fed's assets totaled less than $1 trillion before the Great Recession, and only about $2 trillion just after.[3] Consider also the Congressional Budget Office baseline forecast for the entire 2021 federal spending budget is $5.1 trillion. And only about $3.3 trillion of revenue will be collected in 2021 by the U.S. Treasury, leaving a forecast budget deficit of over $1.8 trillion.[4]

The sizable and increasing annual budget deficit, and the total U.S. debt, are a concern to many, especially in the longer term. But experienced investors have come to understand how the Federal Reserve's actions often impact the financial markets in the short term. In fact, these "expansionary" programs are designed specifically to stimulate the economy. The stock market is very forward-looking, often moving up or down ahead of the overall economy.

Don't fight the Fed – At the start of the pandemic, in the five weeks ended March 23rd, the S&P 500 lost about 34% of its value. Panic was in the air, and for many investments, there simply were no buyers. Even "safe" money market funds were on the brink of becoming illiquid. The Federal Reserve stepped in, and effectively said "We'll buy" (illiquid securities). And on March 24th, U.S. lawmakers announced an agreement on the $2.2 trillion CARES act, which was signed the next day. The Fed lowered its target interest to near 0%, and launched a number of lending and buying, so called "Quantitative Easing," programs. The market certainly noticed, and took a deep breath. The S&P 500 rose 9.3% that day. One could argue that the market hasn't looked back, fully recovering plus a good deal more since that time.

Investors have learned that loose or expansionary monetary policy helps an economy to recover and/or grow, and tight monetary policy slows an economy down, typically to avoid runaway inflation. To a large degree, it is these expectations that can drive the market ahead of the economy. And it can cut both ways. To this day, the Fed is still buying $120 trillion of government and private fixed income securities each month. With this support and other factors, the stock market has continued to grind higher. But at some point, the Fed will slow down purchases, then stop buying bonds, and either let existing bonds mature, or even start selling them in the open market. The Fed typically looks to do this carefully and gradually, by "tapering" down its bond buying. But again, the market is very forward-looking. In 2013, after years of Quantitative Easing programs launched during the Great Recession, the Fed announced a future tapering of bond purchases. This caused what has since been referred to as the "Taper Tantrum." Investors responded immediately by selling bonds, driving prices down significantly, and driving up interest rates.

Investment words of wisdom have been spoken by many. Warren Buffett once said "Be fearful when others are greedy, and greedy when others are fearful. Sir John Templeton famously said "The four most dangerous words of investing are, it's different this time." And Martin Zweig, a legendary Wall Street investor and analyst, once said "The trend is your friend." Martin also coined the adage "Don't fight the Fed." Sometimes it's hard, but we do our best not to.

Sincerely,

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[1]https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm - Feb 3, 2020 to Feb 3, 2021

[2]Sum total derived from reporting in USA Today and govtrack.us

[3]federalreserve.gov

[4]1/31/21 JPMorgan Guide to the Markets