Why Stocks Don't Care About Rates

5th April 2022

Summary

- **The Fed has told you that they intend to tighten financial conditions to slow growth**
- **Despite surging bond yields, financial conditions remain far too easy**
- **The problem is that equities don't respond to rates so much as the Fed's balance sheet**
- **Equity vol should rise, but until the Fed starts QT, bonds will have to do the heavy lifting**

In his last two public appearances, Jay Powell's message couldn't have been clearer:

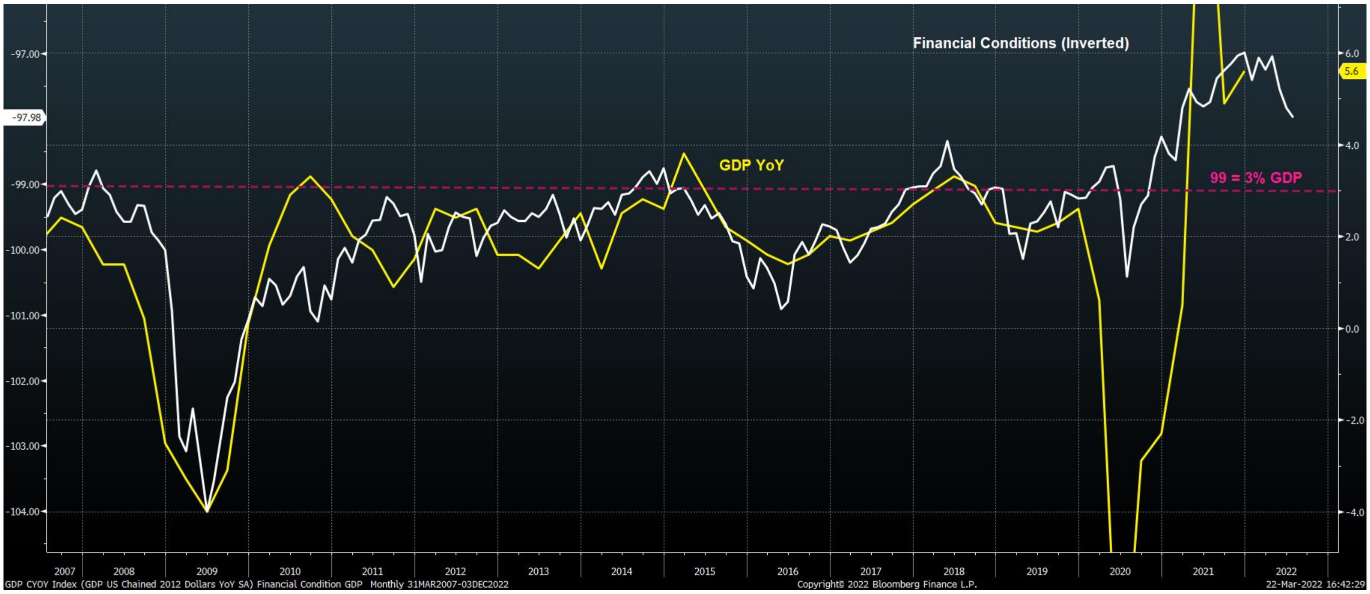
> *"There is misalignment of demand and supply, particularly in the labor market, and that is leading to wages that are moving up, that are not consistent with 2% inflation over time."*
>
> *"The world we have been in for the last 25-years is one where you could really go hard to support the economy when it weakened because you knew that inflation expectations were anchored. For the first time for a very long time, we have high inflation, and we know that we need to restore that. We really do. So, I don't see in the medium term a conflict between the two mandates."*

In other words, absent some exogenous event, which they can't foresee, the Fed plans to tighten policy to slow growth, nail inflation expectations back down, and if that means a weaker labour market in the short-term, tough luck! If you're a central bank cynic like us, the odds that JP actually has the guts to see this through is questionable. However, he will try, and, at least for now, what he said was unequivocally hawkish. The latter is something that, judging by the stunning moves in US fixed income, the bond market has taken to heart. Yet amazingly, risk assets have rallied! So, what's going on?

Before we answer the question, we want to remind you of some of our musings on current monetary policy. First, the Funds Rate and the balance sheet are not the ultimate objectives. They are simply tools the Fed deploys to adjust financial conditions. As JP succinctly said:

> *"So, as you know, policy works through financial conditions. That's how it reaches the real economy."*

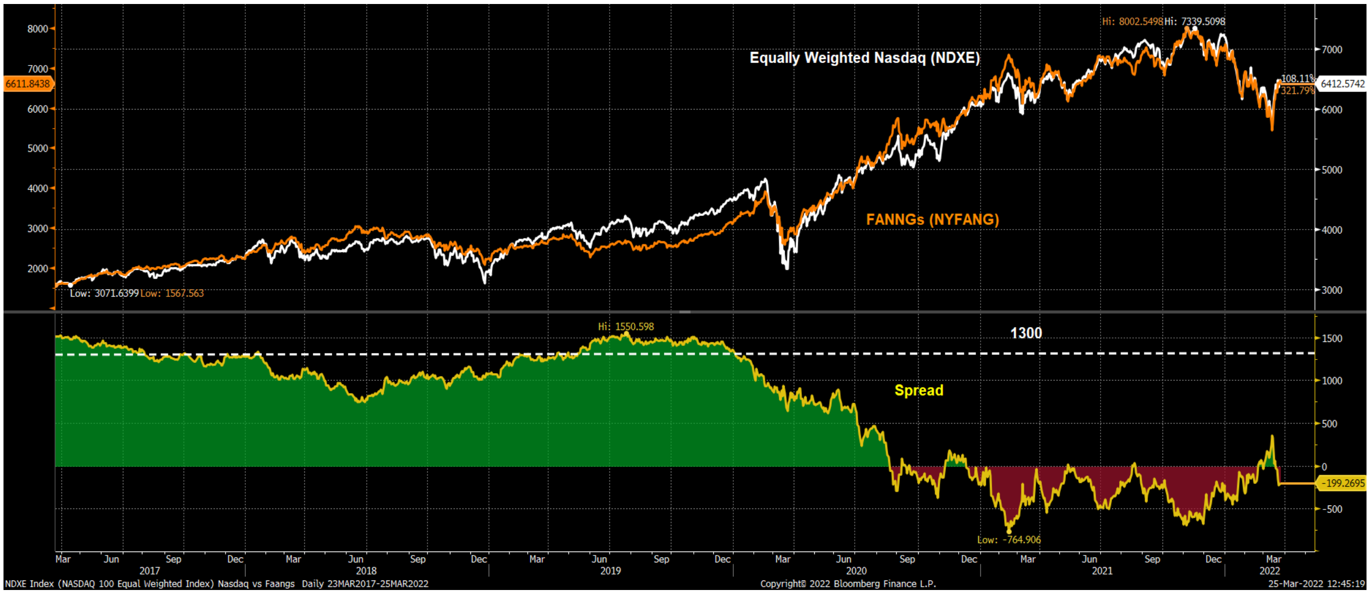
Second, we believe that trend US GDP growth is somewhere between 2-3%. Therefore, even if we are really, really generous and assume that slowing growth to trend is sufficient to re-anchor inflation expectations, we still have some way to go until financial conditions are appropriate ("MI2 Chart Point: The Macro Picture" 6th Jan). Using the Goldman index (GSUSFCI), Financial Conditions, courtesy of the equity rally, have eased considerably in the last week or so and are now commensurate with GDP growth closer to 4.75%. To slow growth to 3%, the index should be closer to 99, i.e., where it was in the first half of 2018, during the Fed's last tightening cycle.



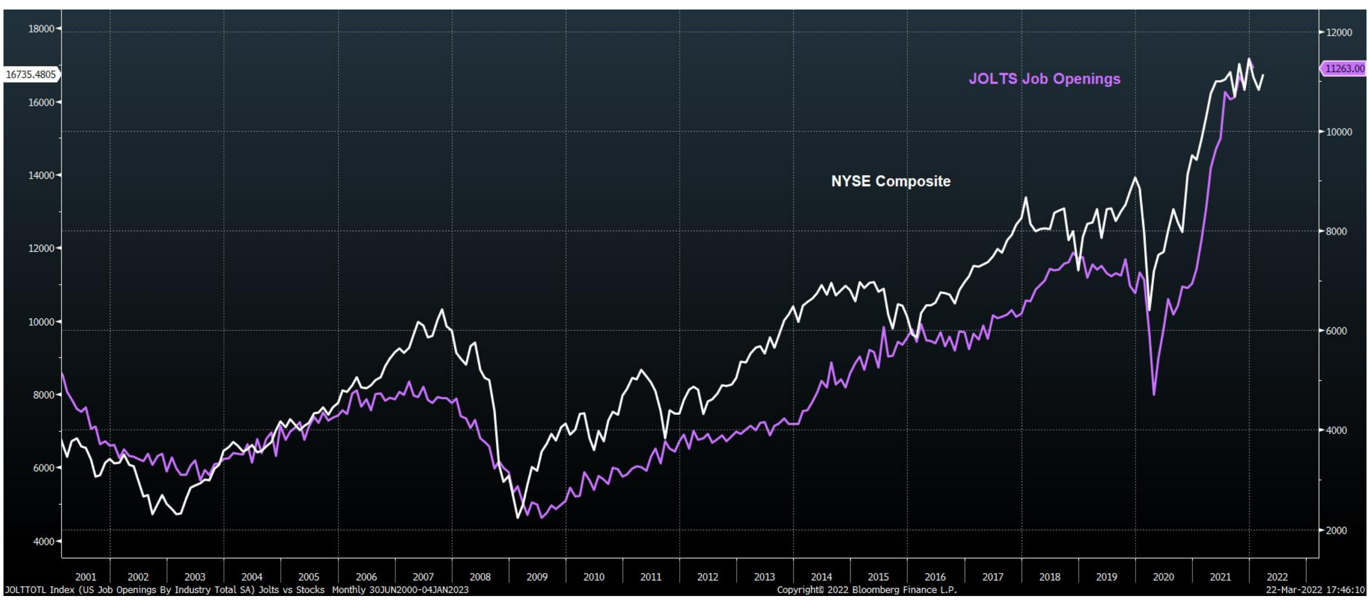
As we have described, a typical financial conditions index is composed of a mixture of bond yields, credit spreads, FX, and stocks ("MI2 Trader: Auditing Market Views" 24th Jan). Taking current prices of those various metrics and comparing them to early 2018, it is clear that rates and credit are fairly priced while the dollar is perhaps a little strong. However, even adopting a conservative approach, for example, using the Equally Weighted S&P index to remove distortions, stocks appear to be 30% overvalued! That, in turn, begs the question, why are stocks bulletproof?

The bulls might argue that it's simply TINA. Alternatively, they might say that Covid taught us that effectively mega-cap tech are the new "ersatz bonds" (" Q4 Roadmap: How to Trade the Macro" 18th Aug 2020). Following that line of thought, with increasing talk of a recession, FAANG should outperform. Given their weighting in the major indexes, FAANGs will support the broader markets.

Interestingly, this narrative has been borne out by recent price action. After a decent bounce, the spread between the Equally Weighted Nasdaq (NDXE) and the FAANGs (NYFANG) has rewidened by 500 points, as the big boys have outperformed again.



However, we don't believe that any of these arguments can justify sustained outperformance. First, at some point, logic dictates that a recession will weigh on earnings, even in mega-caps. Second, the extreme financialisation of the US economy means that it will be nigh on impossible for the Fed to cool the employment market without some correction in equities, which means they will have to keep pushing rates until the penny drops!

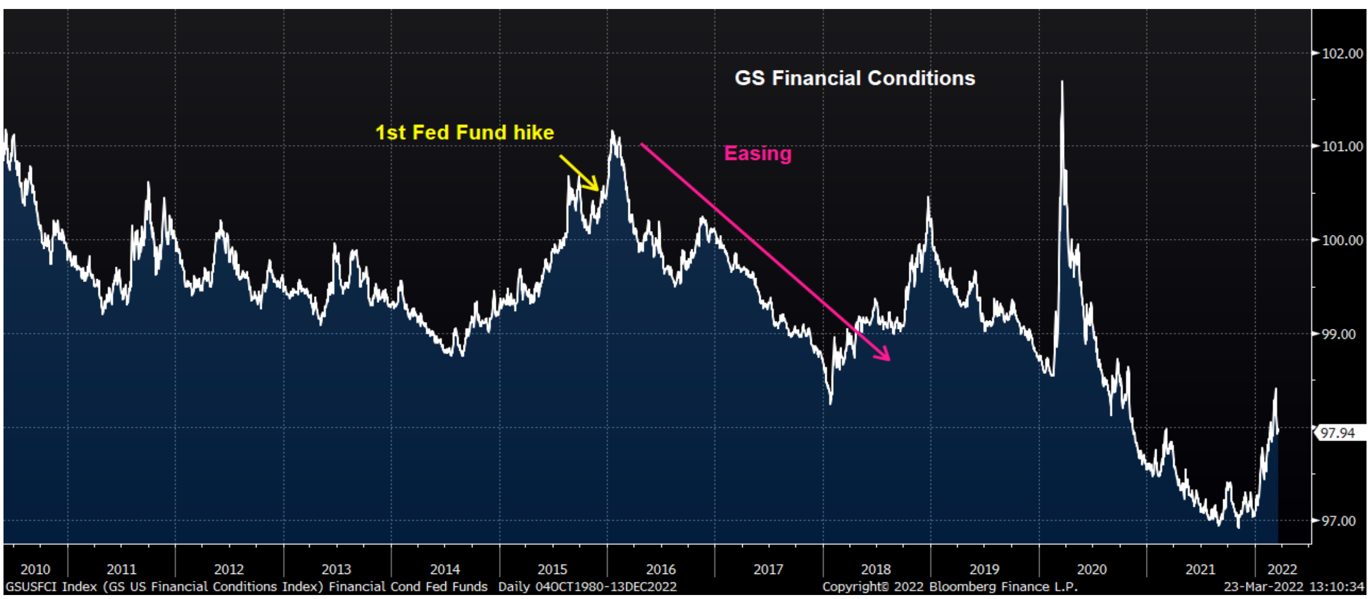


By way of reminder, that's exactly what Bill Dudley said at the end of last year:

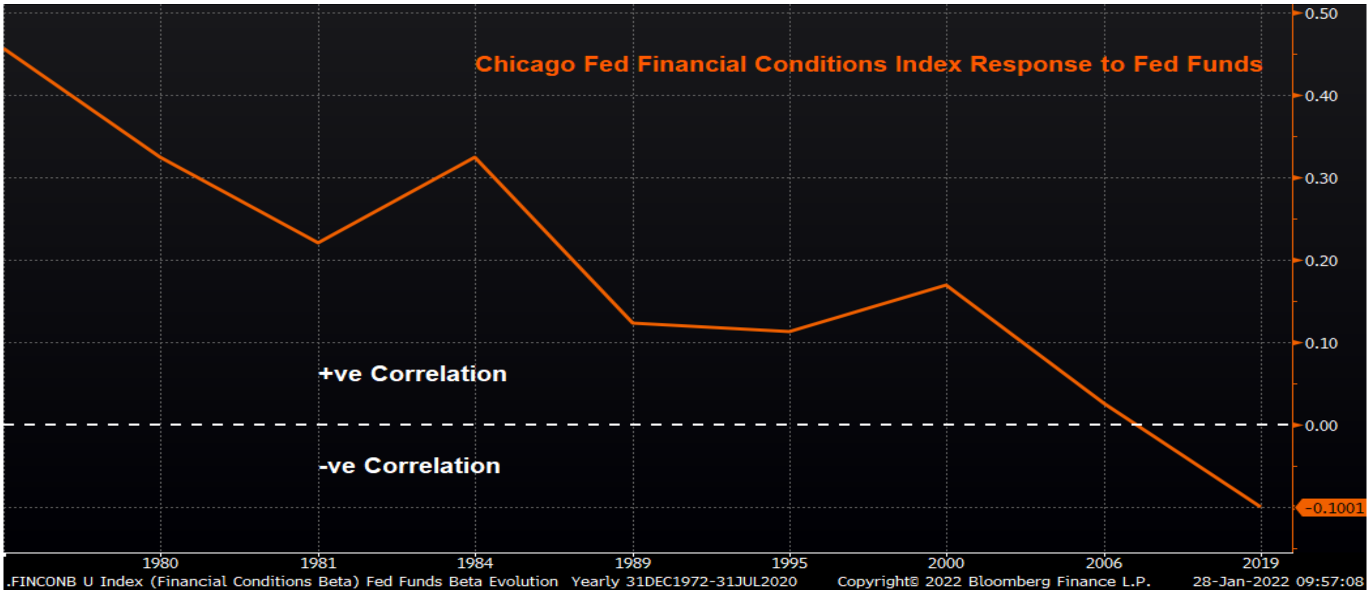
> *"So how high will rates need to go? This depends on how easily higher rates will tighten financial conditions and cool off the economy. So far, there's little sign they'll have much effect. All this suggests, the Fed will have to raise short-term rates by considerably more than what's currently anticipated. The last time the central bank faced unresponsive markets, between 2004 and 2006, it had to increase rates to 5.25% from 1%. That episode may be a better template than the last business cycle".* 3rd Nov 2021

Finally, and most significantly, we think the equity bulls are forgetting that one of the reasons mega-cap tech and growth names outperformed during Covid was the not-insignificant $4.75tln of QE! Indeed, more than any other factor, we believe the balance sheet explains the current resilience of equities to rising interest rates. There is simply too much cash in the system!

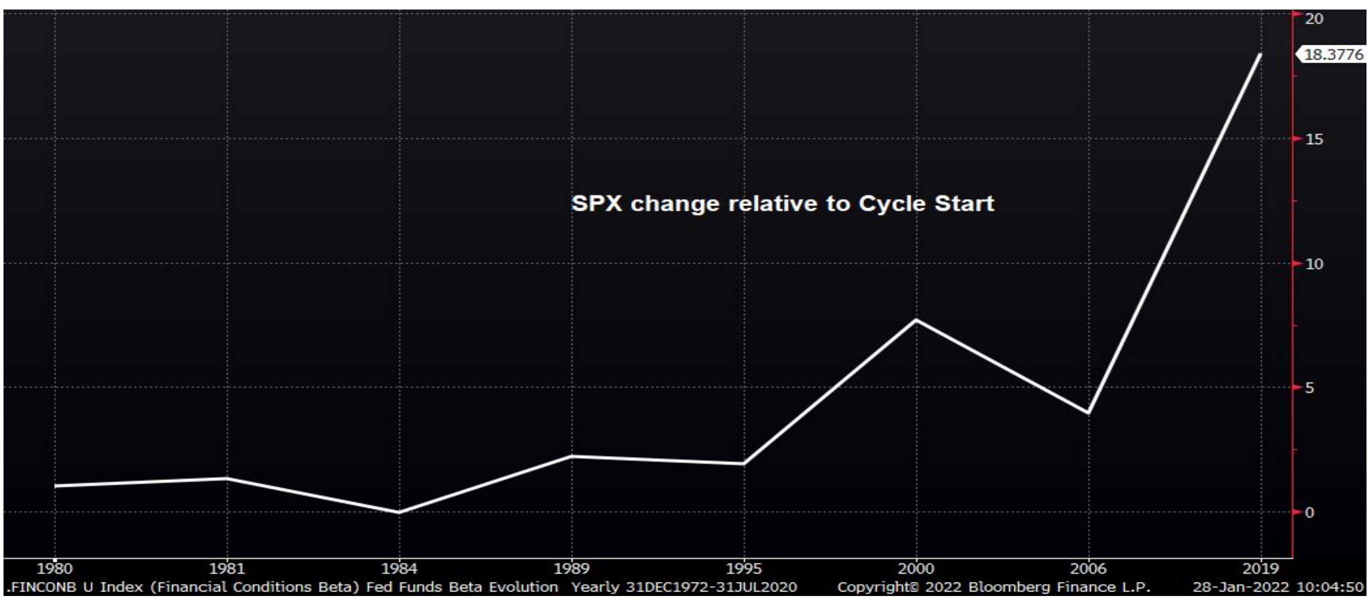
Back in the spring of 2018, we wrote a piece called "Financial Conditions Leave the Fed Behind the Curve". At the time, the Fed was two years into a hiking cycle, yet bizarrely financial conditions had eased!



Further examination revealed it wasn't an aberration. In fact, the response coefficient, or the strength of the response in financial conditions for a given increase in Fed Funds, had been steadily falling for the last 50 years. In part, we believed this was the function of an increasingly over-leveraged economy, whereby smaller and smaller increases in Funds were necessary to slow activity. However, that still didn't explain why (post the GFC) the relationship had turned negative!!

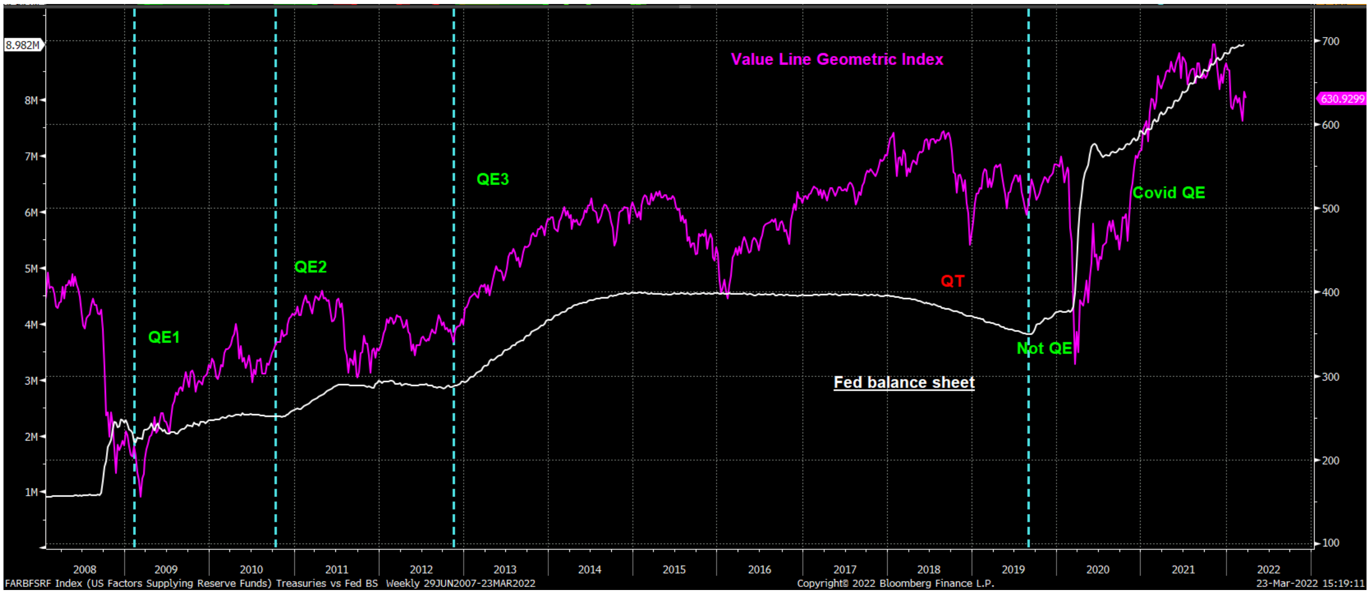


Digging a little deeper, we examined the response of each component of financial conditions during tightening cycles. What we discovered was that equities behaved quite differently from their peers. Far from reacting negatively to rate increases, especially since the GFC, equities have typically rallied as Fed Funds have risen. This trend has massively accelerated during the 2015-18 tightening cycle and still persists today, judging by the current price action.

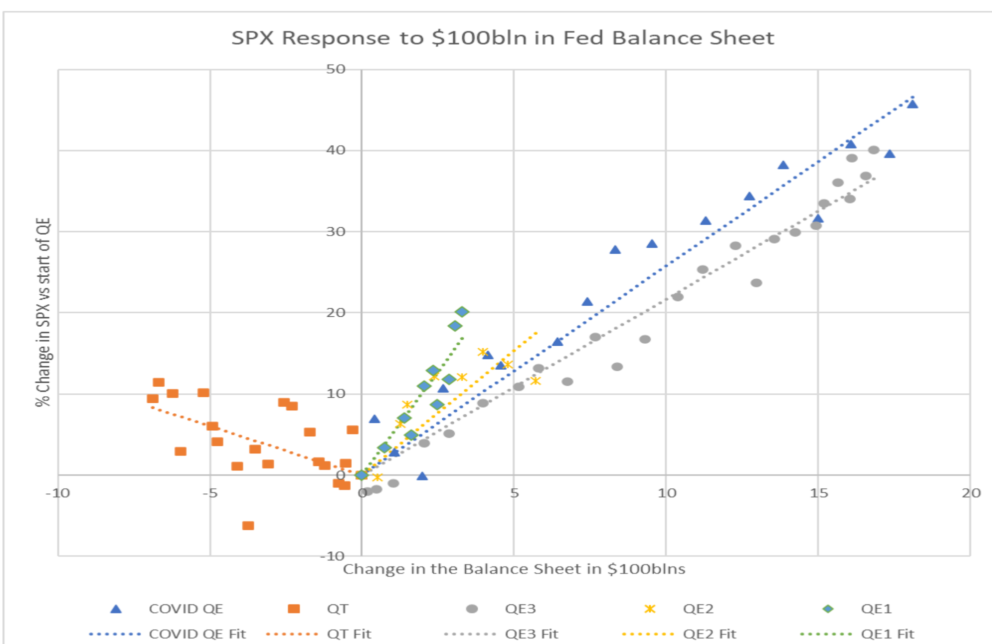


Having established that stocks were essentially neutering the Fed's ability to tighten conditions via the Funds rate, the question was how that was possible? In part, we suspected the explanation was behavioural, i.e., in the 25 years since Greenspan first deployed the "Put", investors have learnt to call the Fed's bluff whenever stocks were threatened by higher rates! However, on its own, we still didn't believe that was an adequate explanation, so we turned our attention to the balance sheet.

Back in 2018, the use of QE was only a decade old, and while the anecdotal evidence suggested that stocks were very sensitive to liquidity, we lacked sufficient data to do a full analysis.



Four years on and armed with new data, the conclusion is clear. While the exact response of the S&P differed between the various bouts of QE, it moved in lockstep with the balance sheet. In terms of QT, we only have one period to analyse, and counterintuitively, stocks initially rallied even as the Fed drained liquidity. However, don’t forget that in late 2017, Trump passed his huge corporate tax cut, and we suspect the subsequent profit windfall explains how the S&P defied the gravitational drag of QT, at least initially in 2018.



To sum up, the Fed is trying to tighten financial conditions to counter inflation, which requires slower growth. But they are being thwarted because stocks only seem to care about the balance sheet. The complacent dynamic faces upcoming challenges. It won't be until the May FOMC Meeting that the FOMC will announce their plan for the balance sheet, but it is likely we will glean some more detailed information ahead of that from the release of the Minutes to the March meeting. (Released tomorrow, Wed 6th April). Received wisdom for the May meeting is that while we could easily get a 50bps hike, QT will be limited to the natural run-off rate of the balance sheet, i.e., $90bln a month, although we have heard numbers as high as $125bln. Perhaps, stocks can repeat their early 2018 Houdini-like performance? We doubt it. This time the macro backdrop is vastly different with out-of-control inflation, which is a tailwind for higher yields. We are updating our inflation forecasts as we write, and they aren't pretty. For those companies with limited pricing power, margins are going to get crushed, as we discussed in "Equities: A Glaring Dilemma" 27th Sept 2021. At a bare minimum, it is noteworthy that historically as soon as the Fed ends QE, equity volatility rises. Higher volatility should gnaw away at the market's risk-taking ability until something breaks!