The Federal Reserve and the Safety Net

April 13, 2020

Finally, a welcome record stock market rally characterized last week with the S&P 500 rallying by 12.1%, the biggest weekly gain since 1974! We attribute a good part of this rally to portfolio rebalancing that we discussed in a prior Missives. Given the decline in stocks and the rise in bonds during the first quarter, we expected to see a stock rally simply because institutional managers had to get their portfolios back to a target bond/stock allocation. Over the weekend, we enjoyed reading many market observers explaining why the market had such a rally with none of them citing the rebalancing of portfolios. Usually these rebalancing activities take place quarterly so keep your eye on the levels of stocks and bonds late in June to see if another rebalancing event could dominate prices early in July.

We will not attribute the entire rally to rebalancing because the Federal Reserve deserves some credit (no pun intended) for that rally. On Friday, the Fed announced another financial support program for the private sector committing to buy securities such as high yield and junk bonds. Janet Yellen, the last Fed chairman, recently advocated for buying corporate bonds and common stocks if the need arises. The commitment triggered a strong rally in corporate bonds as well as the stock market. The commitment of $2.3 trillion confirmed that the Fed would do what it takes to keep the economy on a survivable track until the government eliminates the coronavirus and America can get back to normal. The Fed provided the safety net before, both in the mortgage meltdown of 2008 and the stock market crash of 1987.

The Fed is demonstrating its power by building a safety net under the economy when growth is threatened. The Fed can create money at will. For those of you who have tracked the progress of Modern Monetary Theory (MMT), the Fed's recent actions demonstrate that theory in action. Virtually all traditional economists have rejected MMT on the basis that "writing the check" to keep the economy from falling on hard times would trigger hyperinflation. We know that such a result did not follow the Fed's series of QE activities to turn the economy back up in 2009, as inflation remained dormant – and has been at record lows ever since! There was no big tax increase or federal borrowing spurt to pay down the Fed's acquisition of trillions of dollars in mortgage-backed securities. Forecasters say that the current policy of fiscal and monetary stimulus could produce budget deficits of $5-7 trillion and explode inflation and interest rates. If the traditionalists are right, we would recommend owning stocks and other real assets and selling bonds. If they are wrong, which is our belief, and MMT proves accurate then stocks are the only game in town.

The last two weeks brought bad news on unemployment (increases of 6 million-plus for the last two weeks with more increases to come) yet stocks still rallied. Remember that the stock market is forward-looking and that the stock prices reflect the forthcoming negative economic data. Tomorrow marks the beginning of corporate reporting – the numbers are going to be bad and many companies will likely defer reporting, and certainly predicting, earnings going forward. The stock market will suffer from indigestion as a result, but we will get back on a growth trajectory. Let's hope for sooner rather than later!

211 King Street • Suite 106 • Charleston, SC 29401 • 843-342-3044 • www.vcm.us.com