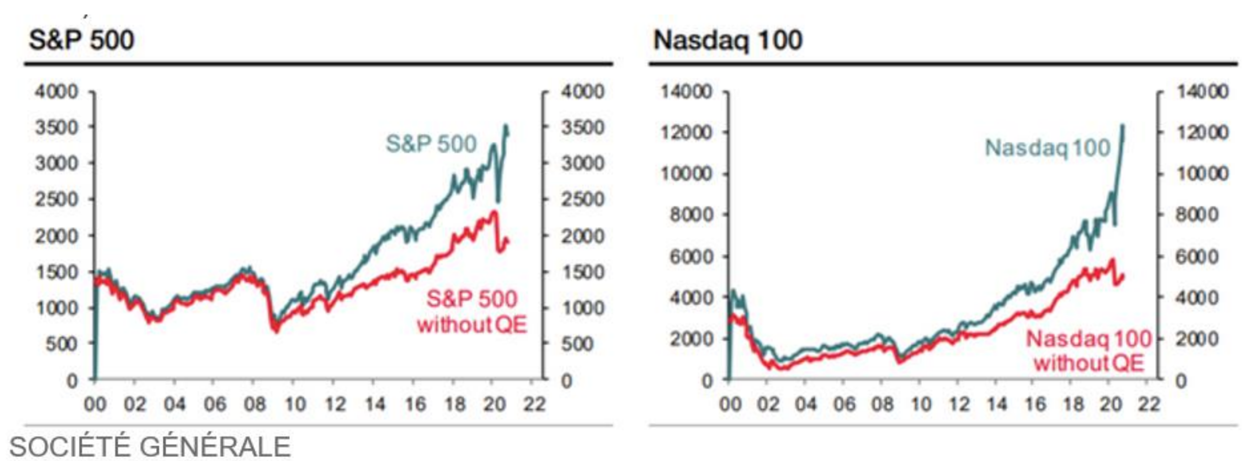
Policy Impact on US Markets : An Important Study by Society Generale

With the recently closed books on 2020, we leave behind an 11-year period of massive Government and Fed policy influence on the securities markets. Can you remember back to 2009 and Quantitative Easing[1] (QE)? Well, that was just the start! Will intervention continue and have the markets become junkies to liquidity, securities buy-backs, near zero interest rates, and other “fixes”? We have all read about the market distortions such policies have created albeit to stabilize the economy and markets through traumatic events such as the great recession and the Covid pandemic crash. What exactly is going on with the markets today and what can it tell us about the future?

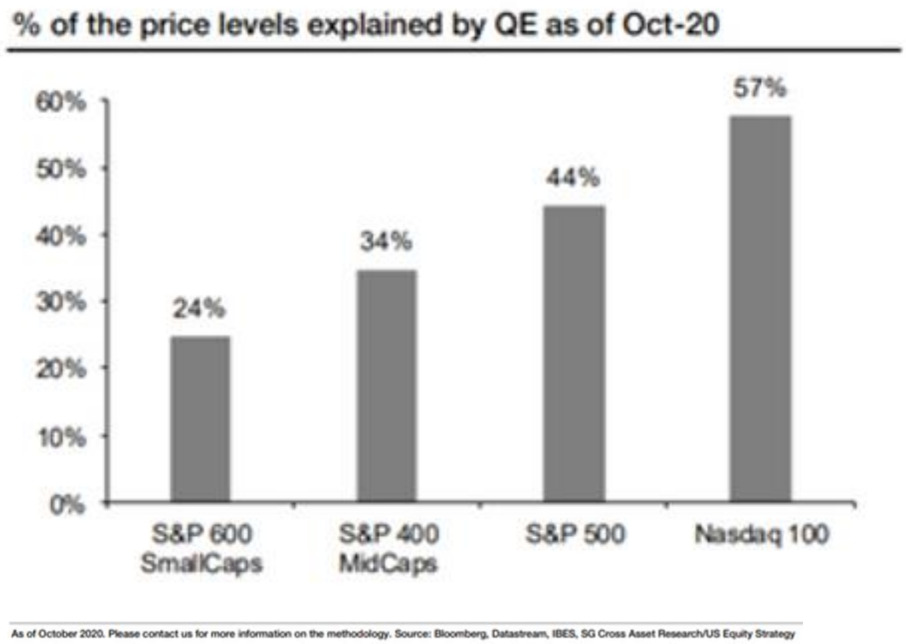
Recently, these distortions are most evident in the stock market. In 2020, we saw a massive decoupling of the US stock market and the US economy. The stock market actually had a record rebound, during a recession, after the fastest and most severe drop the stock market has ever seen! To understand the impact of policies one must anticipate how future markets may behave with and without continued stewardship of fiscal and monetary policies.

Society Generale recently provided some very important analysis[2] into understanding the degree of market “interference” due specifically to FED policy. Their analysts looked at the S&P 500 and Nasdaq 100 levels over the last 20 years determining that the S&P 500 500 (SPX) would be around 1,800 rather than 3,300 and the Nasdaq 100 should be closer to 5,000 than 11,000, the latter of which are approximate levels at the end of October 2020.

The timing of the Fed policy impacts is clearly visible from 2009 onward in the graphics below.



This very important study further detailed the percentage impact for various sectors of the US equity market as indicated below:



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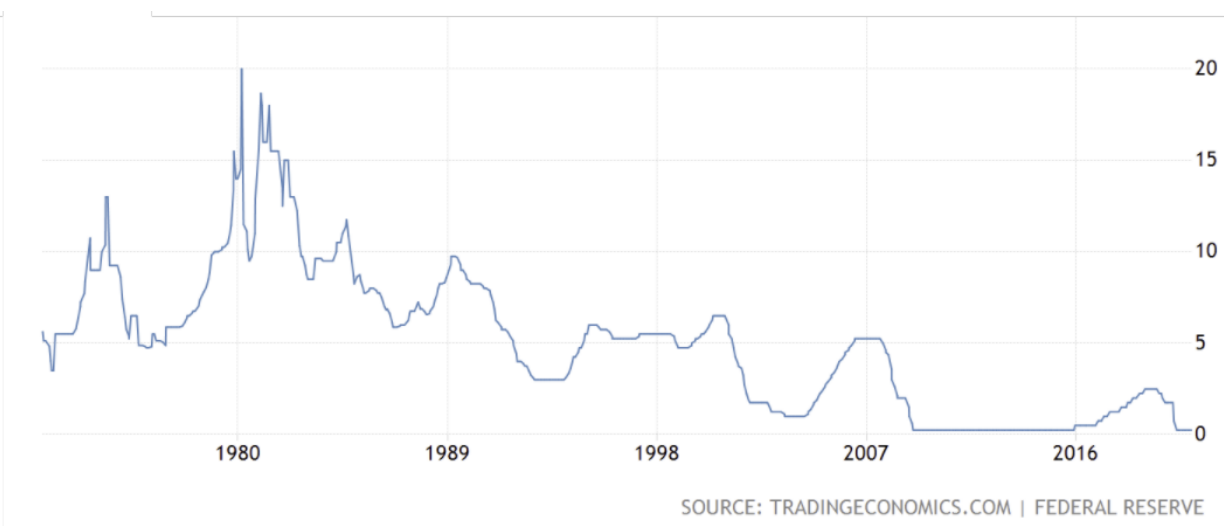
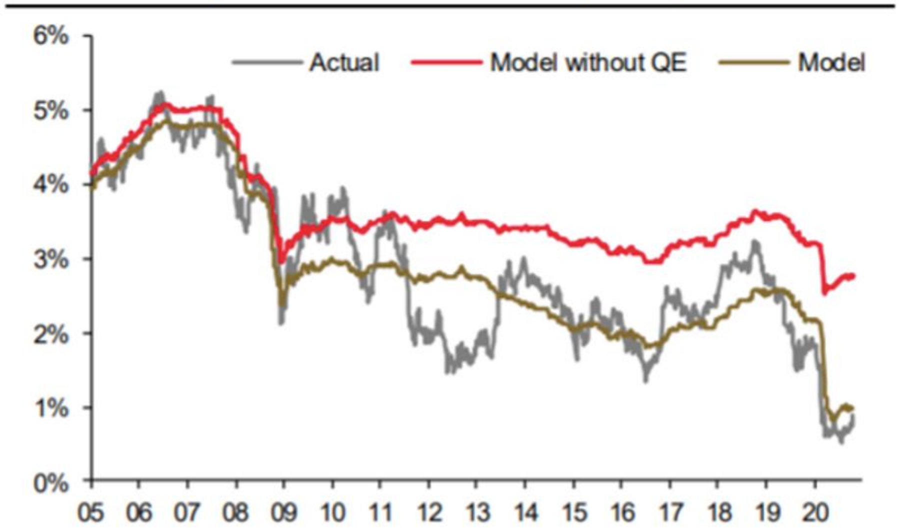
The impact on bonds is a bit less clear. Bonds and stocks are slightly inversely correlated meaning when one goes up the other tends to go down. Bonds themselves have their prices move in the opposite direction of yields. Therefore, we saw strong bond returns in the decreasing interest rate environment which began in the early 1980's, with rates nearing 20%, through the zero rate setting policy of the Fed in the great recession (2009) and again in March 2020.



Looking at a mix of macroeconomic indicators back to 2005, the Society Generale analysts then estimated the extent of Fed interest rate policy to be 180 basis point or a 1.8% reduction in the 10 year Treasury yield as indicated below.

Cumulative impact of Fed QE on UST 10y: 180bp since 2009



Indicators used: Fed balance sheet, Fed funds rate, US 10y breakevens, Conference Board US
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Another important finding was that prior to Quantitative Easing and its market manipulations, US stocks were more often the driver of the bond market. That is, as risk appetites shift due to stock market moves, investors either preferred or shunned bonds. Our new environment of massive policy influence in the markets has apparently shifted this relationship to one of changes in bond yields affecting movements in equity markets. Clear evidence exists that when interest rates are near zero, and may produce negative “real” (after inflation) returns, we see dollars flow into the equity markets pushing up prices. This effect helped the stock market set a new record for the longest bull cycle, interrupted by the 2020 Covid Crash, only to resumed shortly thereafter, when interest rates were returned to zero.

Understanding the insights and/or validations provided through this research helps us to understand possible courses for the markets going forward. The FED now seems committed to a low interest rate policy unless sustained high inflation rates (2+%) appear. They wish to void overtightening risks and other mistakes of the past. Recent fiscal policies, such as tax reduction, increases and extensions in unemployment benefits, loan repayment deferrals and sustenance checks for citizens will serve to compound the effects of easing monetary policy. Should all this continue, equity markets should continue to find supportive cash flows and stock values will continue to inflate. Might the eventual outcome be a huge bubble popping? Will markets remain stable, due to continue policy efforts, only to significantly underperform historical averages until the markets’ intrinsic value catches up with current market valuation levels. Stay tuned as we follow the policies, the economy and markets for you.

Carl Terzer, Principal

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[1] **Quantitative easing (QE) is a monetary policy whereby a central bank purchases at scale government bonds or other financial assets in order to inject money into the economy to expand economic activity. The market impact was further enhanced by dropping interest rates to zero flushing the economy and markets with liquidity.**

[2] **As published in *MarketWatch* from a Society Generale research report from analysts** Sophie Huynh and Charles De Boissezon