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The S&P 500 Pushed The Federal Reserve Too Far - Now It's Too Late

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Summary

- As the S&P 500 continued to rise into late September, the Federal Reserve tightened monetary policy too far.
- The monetary and credit aggregates suggested monetary policy was biting aggressively before equities started to decline.
- The US economy is vulnerable moving into 2019.
- The S&P 500 gave investors a false sense of confidence in the economy.
- What's next - the Fed has blinked, but the market won't recover?

The S&P 500 Pushed The Federal Reserve Too Far - Now It's Too Late

On September 26th, at the peak of the euphoria in the stock market, I penned a research note titled, "**The S&P 500 Will Push The Federal Reserve Too Far**," in which I argued that investors and analysts were not paying attention to the underlying economy and impacts of monetary tightening and that the S&P 500 was going to cause (or had already caused) the Fed to tighten monetary policy too much. Fast forward a couple of months and the entire picture has changed.

The S&P 500 Will Push The Federal Reserve Too Far:

Source: EPB Macro Research

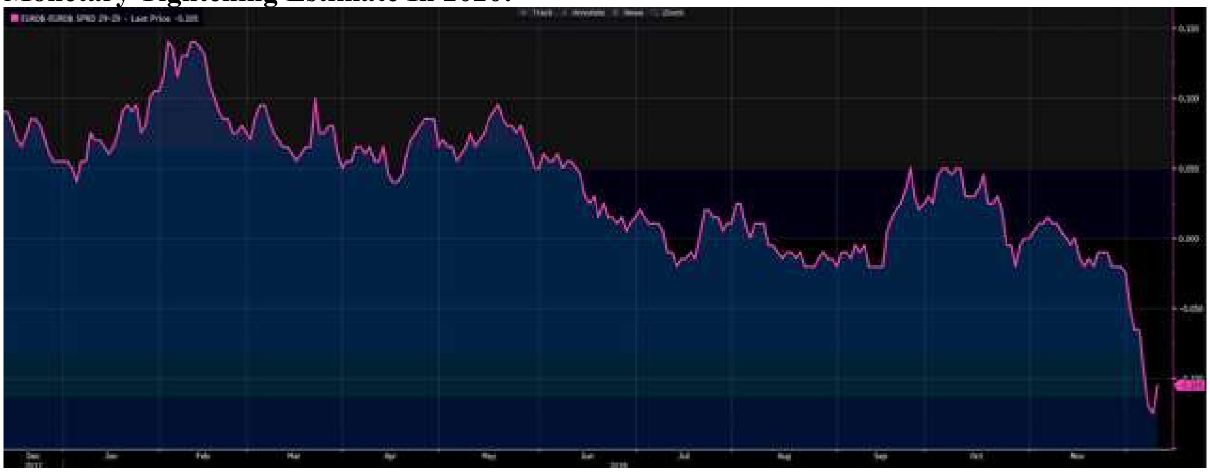
At the end of September, when the S&P 500 ([SPY](SPY)) was hitting new all-time highs, it was hard to find anyone, analyst or investor, who was making the call that the Federal Reserve had tightened monetary policy too much already. At that time, consensus estimates were fully pricing in a rate hike in December and, as the Eurodollar chart below shows, an additional 50 basis points, or two rate hikes in 2019. Today, the market is pricing in just 12.5 basis points of tightening in 2019 or half of one rate hike. Quite a dramatic change in expectations that most analysts missed.

Monetary Tightening Estimate In 2019:

Source: Bloomberg

Even more dramatic, at the time of the last writing near the beginning of October, the market was pricing in an additional 5 basis points of tightening in 2020. Today, the market believes we will see easing in 2020.

Monetary Tightening Estimate In 2020:



Source: Bloomberg

In the September note, I made the case that the Federal Reserve had already gone too far in monetary tightening, and the monetary and credit aggregates proved that monetary tightening was already biting; watching the stock market and not the underlying economy was a mistake. Also, it was clear in September, a point I proved in the earlier note as well, that looking at housing, auto-sales, and durable goods consumption, that the US economy was already slowing. Nevertheless, by staring at the stock market, most missed this unfold before their eyes.

I also argued that it would take a decline in the stock market for the Fed to pass on a rate hike in December rather than a change in the economic data.

Using history as our guide, the Federal Reserve will forgo further tightening measures when market volatility rises despite having two check marks next to their dual mandate.

The Federal Reserve is likely to continue to tighten monetary policy if asset prices remain elevated. A pause to monetary policy actions will come first from market volatility before a data-driven response because, as I will show below, monetary policy is far more aggressive than most realize. - **September 26**

I made the case that monetary policy had already gone too far based on the impacts to the monetary base, money supply, bank asset growth, bank credit growth and a series of high-frequency economic data points.

I want to go over the thesis that led to the conclusion that monetary policy had already gone too far and then argue why it is now too late for the Fed to do anything about the overly aggressive monetary tightening. I will close with my stance on what the proper portfolio positioning is for the given environment.

Nearly everyone agrees that the pace of monetary policy will be dramatically reduced in 2019 and 2020, but my fear is that investors only see that now due to the decline in equity prices rather than the host of economic data that supported the thesis back in September.

Monetary policy acts with a lag. It can take up to one year for the full effects of a tightening measure (rate hike) to ripple through the economy. In September, I wrote:

By the time the S&P 500 responds, such aggressive policy will be hard to reverse when the economy needs it most. - **September 26**

Let's take a look at the same monetary and credit aggregates in addition to the same economic indicators to see where we stand relative to late September. It is likely that the Federal Reserve has already pushed monetary tightening too far and started the economy on a glide path towards a more serious deceleration in growth.

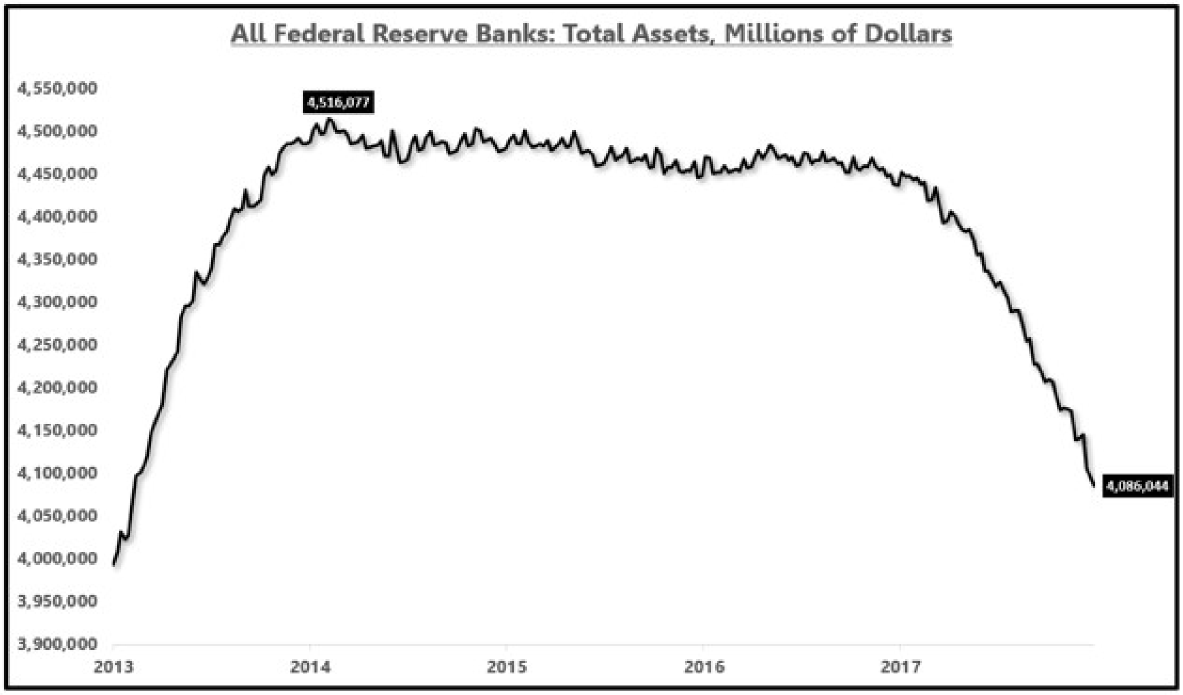
What does this mean for the S&P 500? Will it recover? If the Federal Reserve pauses on rate hikes going forward, will that be enough to save the market? Let's explore those questions.

Current Monetary Policy

As I did in the last note, I want to start off with a quick summary of the current monetary policy to set the foundation for the rest of the piece.

In addition to raising the Federal Funds rate to an upper limit of 2.25%, perhaps reaching 2.50% on December 19th (the next FOMC meeting), the Federal Reserve has been reducing their balance sheet at an accelerating pace in a process called Quantitative Tightening "QT" Starting in October, the pace of QT hit a peak rate of $50 billion per month in asset sales, and it is expected to stay at that rate throughout 2019.

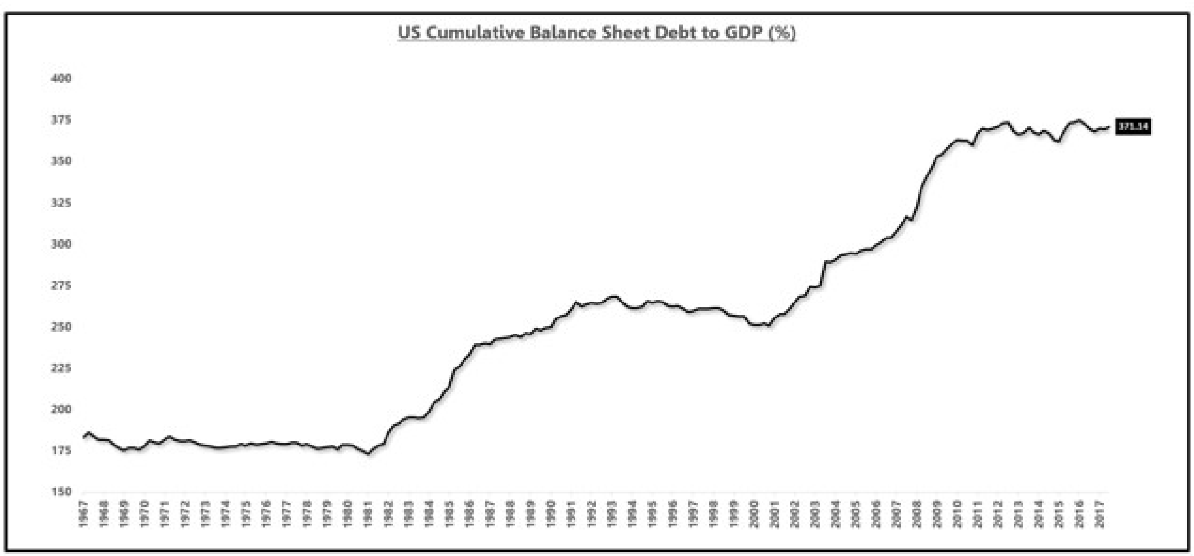
All Federal Reserve Banks: Total Assets:



Source: Federal Reserve, EPB Macro Research

To summarize, the Fed is (was) raising rates and is engaging in QT at a "peak" rate. A tremendous amount of monetary tightening for an economy with nearly $70 trillion in aggregate debt between the federal government, state and local government, corporations and households (~370% of GDP).

Aggregate Economic Debt To GDP (Excluding Off-Balance Sheet/Unfunded Liabilities):

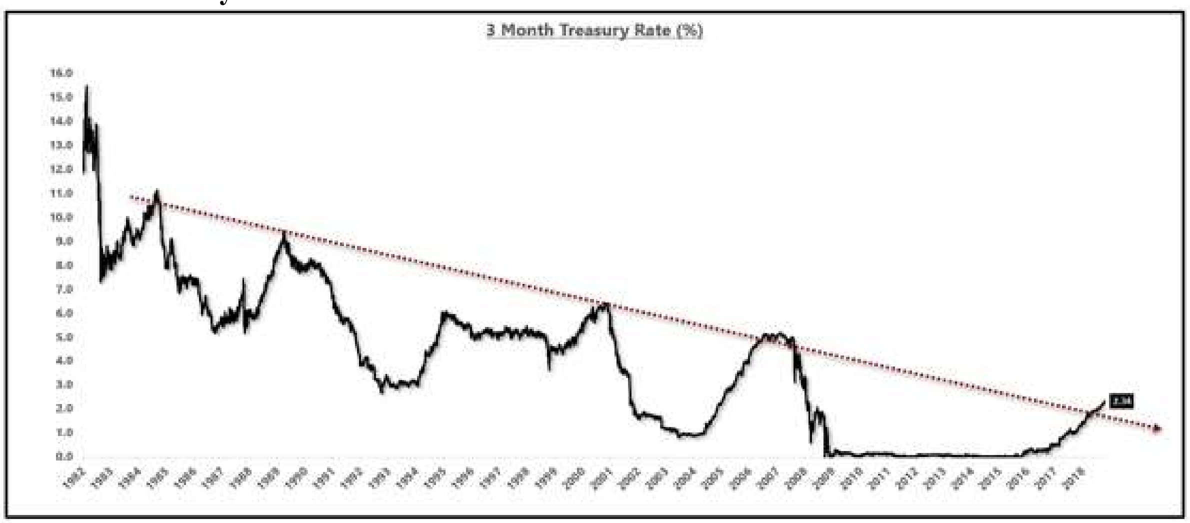


Source: Federal Reserve, US Treasury, BEA, FRED, EPB Macro Research

Most critics of this analysis suggest that monetary tightening is still quite minor relative to history, but that is a one-factor analysis that does not incorporate the relative indebtedness of an economy at the time of monetary tightening.

Short-term interest rates (or the Federal Funds Rate) have made a series of lower highs each economic cycle because the economy starts to contract at a lower point each time due to the amount of debt. With higher amounts of debt, the economy can only handle ever lower interest rates. The monetary tightening that is taking place today is very extreme when looked at in the context of how interest rates impact the cumulative debt load.

3-Month Treasury Rate:



Source: Federal Reserve, EPB Macro Research

In short, the current stance of monetary tightening is and has been highly aggressive. Investors turned a blind eye to how aggressive the monetary tightening has been due to rising equity prices. Now that the stock market has dropped, the pace of monetary tightening is scaring investors. It is too late; the Federal Reserve already pushed it too far.

Monetary policy works with a lag. The impacts from the last rate hike are yet to be seen as companies still have to roll over existing debt into higher interest rates, suffering a larger debt burden and new real estate projects become uneconomical due to higher interest rates.

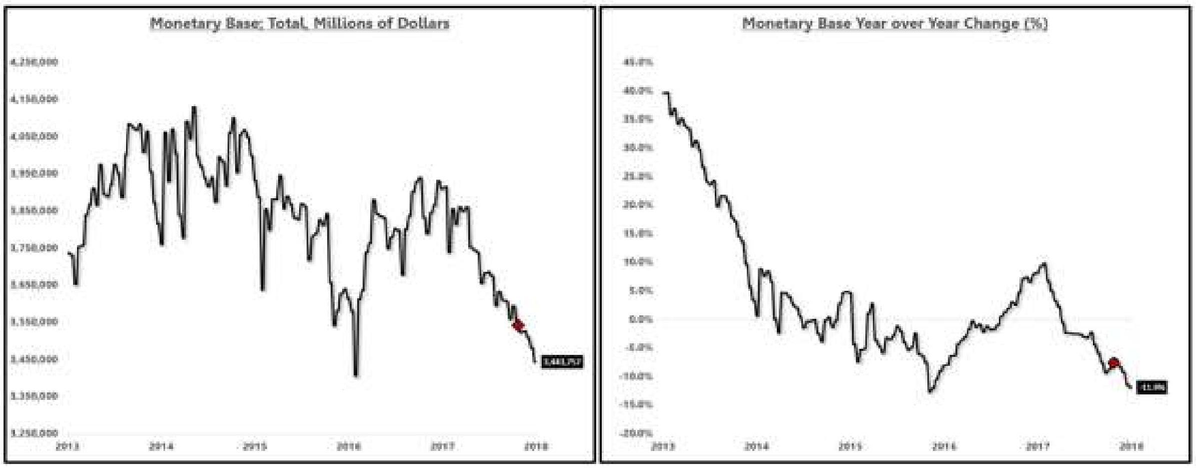
The monetary and credit aggregates, in addition to the economic data, will show that the Fed tightened the economy into a slowdown, and it's too late to reverse course, the S&P 500 will feel it.

Impact To The Monetary Aggregates

The process of monetary change starts with the Monetary Base or "high powered money." The monetary base has been in sharp contraction as the Federal Reserve tightens monetary policy. The monetary base is down roughly $700 billion from the peak at the end of 2014 and is contracting a current rate of 12% year over year.

The red diamond indicates where these indicators were at the end of September at the time of the last writing. As the chart below indicates, the monetary base has contracted more since the previous writing.

Monetary Base In Millions (LEFT) | Monetary Base Year over Year Change (RIGHT):

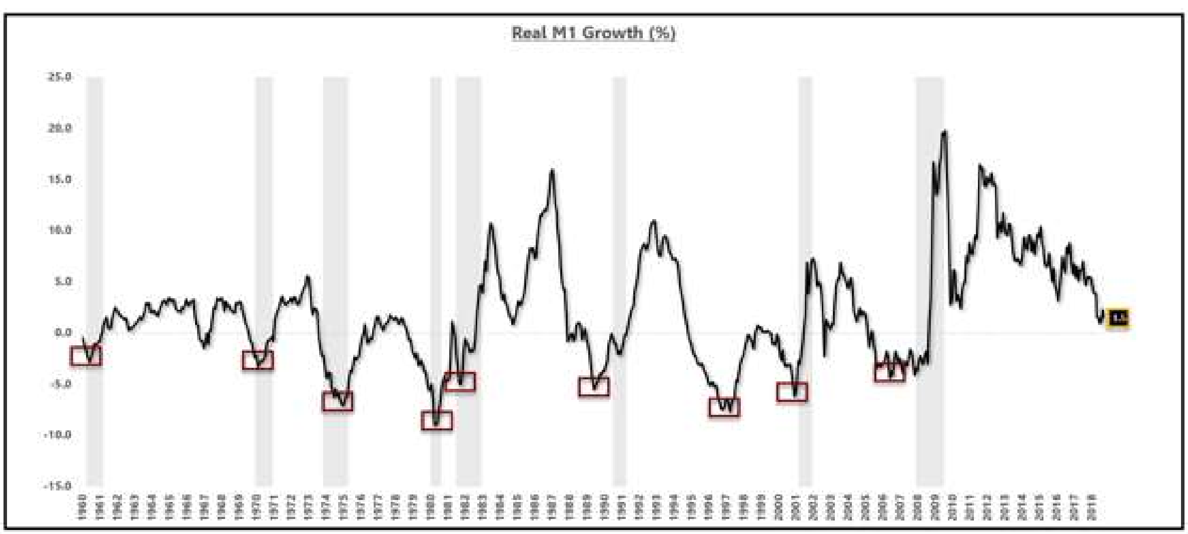


Source: Federal Reserve, EPB Macro Research

The monetary base multiplied by the money multiplier or "little m" results in the broad money supply or "M2". The growth rate in M2 + the growth rate in the velocity of money equals nominal GDP growth, so the trending direction in the growth rate of the money supply provides critical information to the future direction of GDP growth.

In order to relate the changes in the money supply to real GDP growth, we must deflate the money supply by the Consumer Price Index to arrive at real M1 and real M2. M1 is a better leading indicator of economic activity than M2, so a look at real M1 will be used for a proxy on the trending direction of the money supply. After deflating M1 by the Consumer Price Index, we can start to understand the severity of the contraction in monetary policy.

Real M1 Growth Year over Year (M1 Deflated By CPI):



Source: Federal Reserve, EPB Macro Research

The real rate of M1 growth has plunged in recent months (due to contractionary monetary policy) down to a rate of 1.5% year over year.

As I wrote in the last note, I don't want to turn this article into a recession forecast because at this current moment, there are virtually no indicators that suggest a recession is a high probability in the next 2-4 quarters. With that being said, however, I do have to acknowledge that there has been a sharp contraction in the rate of money supply growth preceding each significant deceleration in economic activity.

If the Federal Reserve continues to tighten monetary policy and/or continues to reduce their balance sheet, further contractions in the rate of money supply growth can be expected. If the rate of real M1 growth turns negative, that will be a historically significant event and one that will send a more clear signal that economic growth can be expected to decelerate.

Impacts To The Banking Sector

The impacts on the banking sector have been much more severe than most analysts give credit and part of that has been due to the rise in the S&P 500. Only now that bank stocks have been crashing have many analysts turned to the internals to understand why the pressure has intensified on bank stocks. Bank stocks have wildly underperformed during this period of monetary tightening.

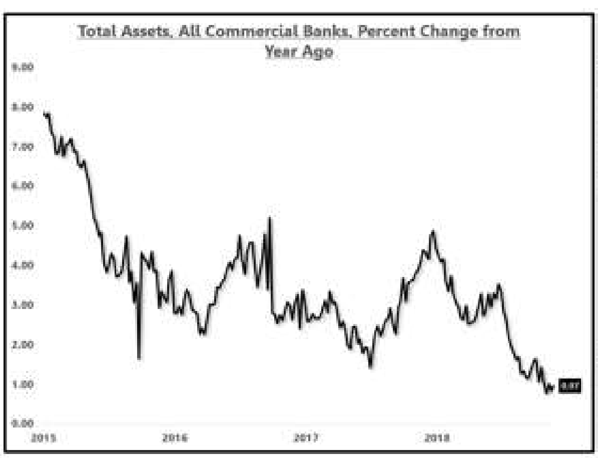
Excess reserves of the banking sector have declined precipitously. This comes as no surprise as excess reserves and the process of debiting and crediting those reserves is the primary tool in which the Federal Reserve controls the monetary base. Many will argue that the nominal amount of excess reserves is still plentiful, which is truthful, but it is the rate of change that matters above the nominal level of reserves, and that can be proven in the growth of various credit aggregates.

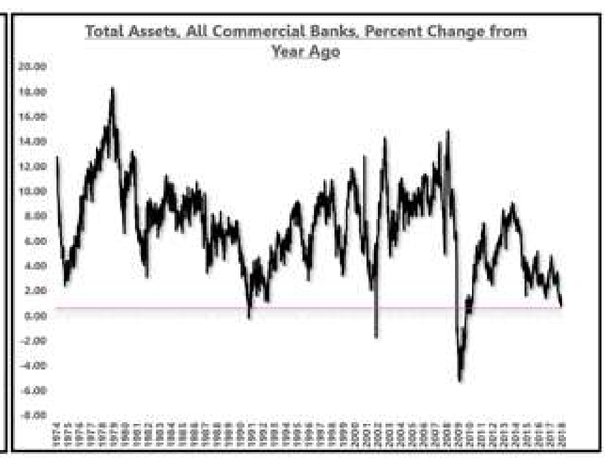
Excess Reserves Of Depository Institutions:

Source: Federal Reserve, EPB Macro Research

A meaningful and rapid contraction in excess reserves has reduced the liquidity of the banking system and has caused a rapid decline in the rate of bank asset growth. Cumulative bank asset growth is at the lowest level of this economic cycle and below 1%. There have only been three other times in history, dating back to the 1970s, where bank asset growth was lower than it is today. Contractionary policy pushed too far and bank stocks are currently paying the price.

Cumulative Bank Asset Growth (Year over Year Change):





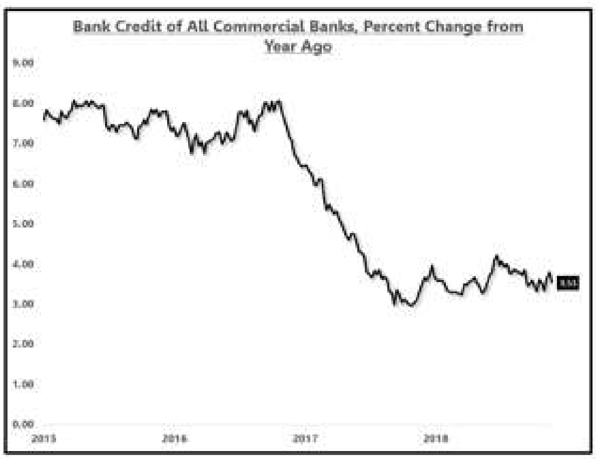
Source: Federal Reserve, EPB Macro Research

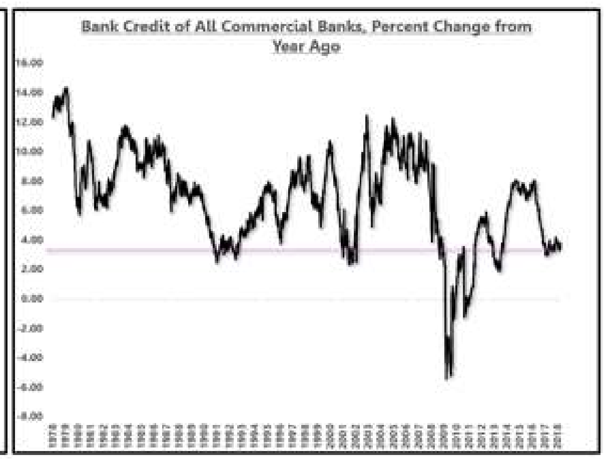
Furthermore, there has been a notable reduction in aggregate bank credit growth starting, unsurprisingly, at the time of aggressive monetary tightening from the Federal Reserve. Bank credit growth, that is total bank loans + total bank securities, has been cut in half from 2016 to today.

The economy will not be able to sustain above trend growth rates with bank credit expansion at half the rate of previous years.

It is also worth noting that cumulative bank credit growth is also at a multi-decade low, excluding the great recession.

Bank Credit Growth (Loan + Securities):

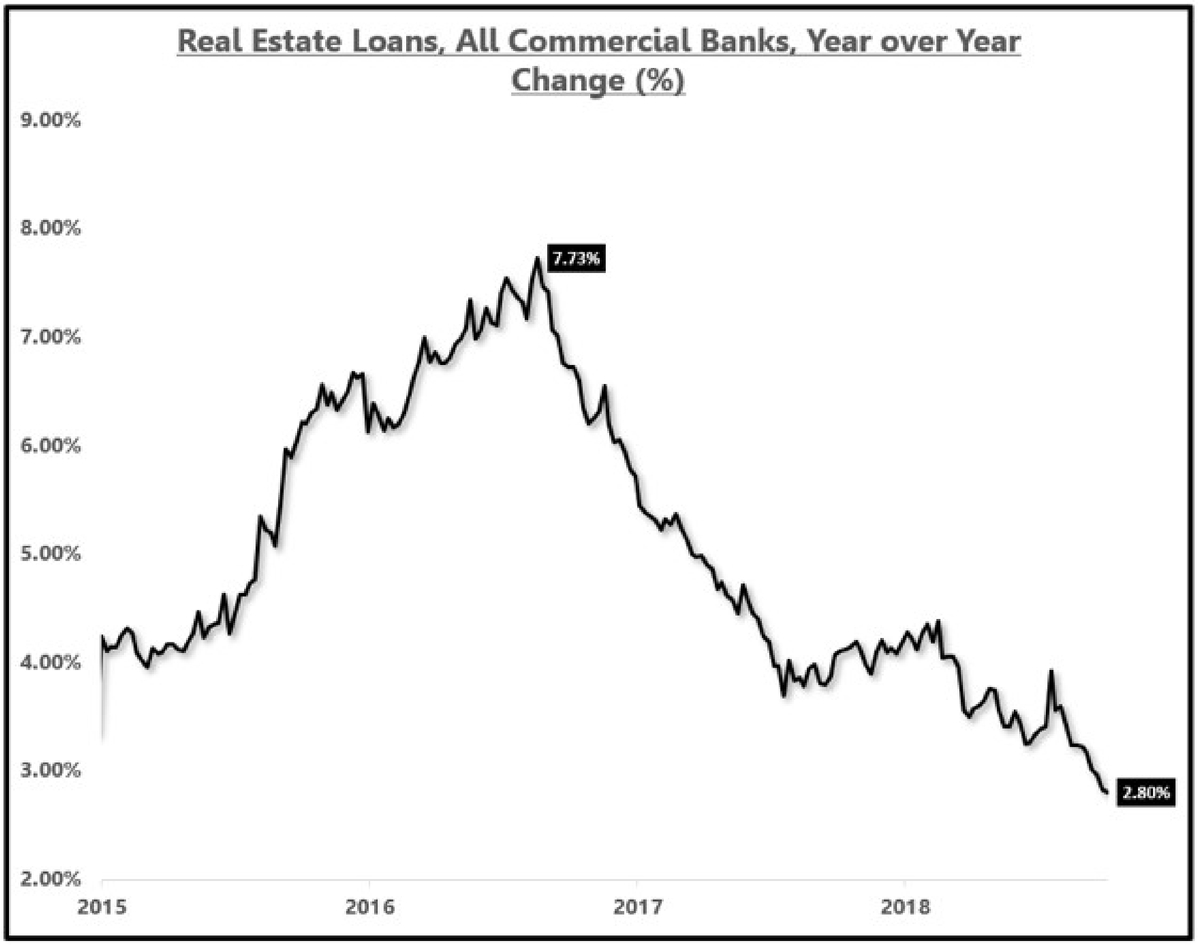




Source: Federal Reserve, EPB Macro Research

Of the various categories that comprise the $9 trillion bank lending industry, including commercial and industrial loans, consumer loans and real estate loans, it is real estate loans that is the largest at $4.3 trillion. Real estate loan growth has fallen off dramatically as the Federal Reserve has contracted monetary policy further providing evidence for the effects of tightening rippling through the economy.

Real Estate Loan Growth:



Source: Federal Reserve, EPB Macro Research

Real estate loan growth has also been cut more than in half since the contractionary policy of the Federal Reserve began.

Higher short-term interest rates, reduced liquidity in the banking system via a reduction in reserves as well as a flattening yield curve have all pressured bank asset growth, bank credit growth and various sectors of bank loan growth.

The yield curve has flattened rather significantly in recent months. Many ignore this indicator unless an inversion occurs but, again, it is the rate of change that matters more than the nominal level of the curve. It is probably worth noting that the yield curve has not inverted prior to every recession, only those post the 1950s.

The marginal changes in the yield curve, steeper or flatter should be monitored for changes in lending conditions as well as the profitability of any institution that borrows short and lends long as the banking sector and shadow banking sector do.

The spread between the 30-year Treasury yield and the 2-year Treasury yield is nearly at a cycle low of 36 basis points and very flat by any historical standard.

30-2 Spread:

Source: Bloomberg, EPB Macro Research

The most popular spread, the 2s10s, dropped to an intra-day low of just 9 basis points on December 4th before widening back to double digits. Today, the yield curve, defined by the 2s10s spread sits just 12 basis points wide.

While there is no clear-cut recession signal yet, the bond market is sending a clear message that growth is going to slow meaningfully over the next several quarters.

10-2 Spread:

Source: Bloomberg, EPB Macro Research

For those who monitor the yield curve closely, there has been an inversion in the front end of the curve. Many growth bulls will say this doesn't matter as the 2s10s spread is the one that has to invert, but anytime a longer maturity bond yields less than a shorter maturity bond, that should give investors pause.

A mismatch in expectations between the market and the Federal Reserve has inverted the front of the yield curve.

5-2 Spread:

Source: Bloomberg, EPB Macro Research

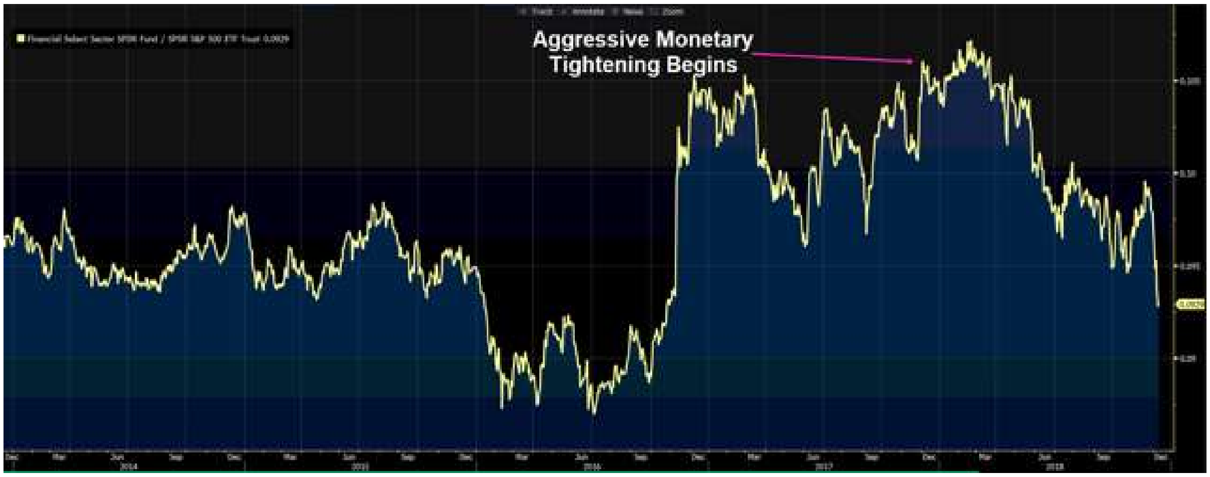
To highlight how these conditions have impacted bank stocks, below is a performance ratio of the iShares Financial Select Sector SPDR ETF (XLF) and the S&P 500 ETF (SPY). At the start of 2018, monetary tightening ramped up as the balance sheet started to get reduced. This added a new dimension to monetary policy that was not appreciated by the market.

The impacts of this policy can clearly be seen in the aggregates discussed above and in the relative performance of bank stocks.

At *EPB Macro Research*, we have been very vocal about shorting bank stocks, starting in May of 2018 and still hold a short position in regional bank stocks (KRE).

The relative performance of XLF compared to SPY has dropped to the lowest level since President Trump was elected which sparked one of the greatest bank rallies in history on hopes of tax cuts and deregulation. Nearly all of those Trump rally gains have faded from the bank stocks due to the Federal Reserve tightening the screws on monetary policy.

XLF/SPY Relative Performance Spread:



Source: Bloomberg, EPB Macro Research

The impact to monetary measures covered in section one as well as the contractionary impact on the growth rate of various bank and credit aggregates is relatively dramatic, given how little tightening has been done from a historical context. It is important to remember that monetary tightening may have been minor relative to history, but once factoring in the difference in present conditions (debt), the pace of monetary tightening was/has been quite dramatic.

Further tightening from the Federal Reserve will exacerbate the trends described above, including pushing the real money stock growth into negative territory, further reducing bank asset growth below 1% on a year over year basis and likely invert the back end of the yield curve.

Before closing, it is worth showing a few important economic indicators and recent trends.

Some Economic Indicators To Monitor

The S&P 500 and stock prices, in general, allowed the Federal Reserve to push monetary policy to the point where we can already see some slowing trends in major economic data points. Again, monetary policy works with a lag, so there will still be negative effects to come through the economy from all the tightening that has already taken place in 2018, even if the Fed decides to change course in 2019.

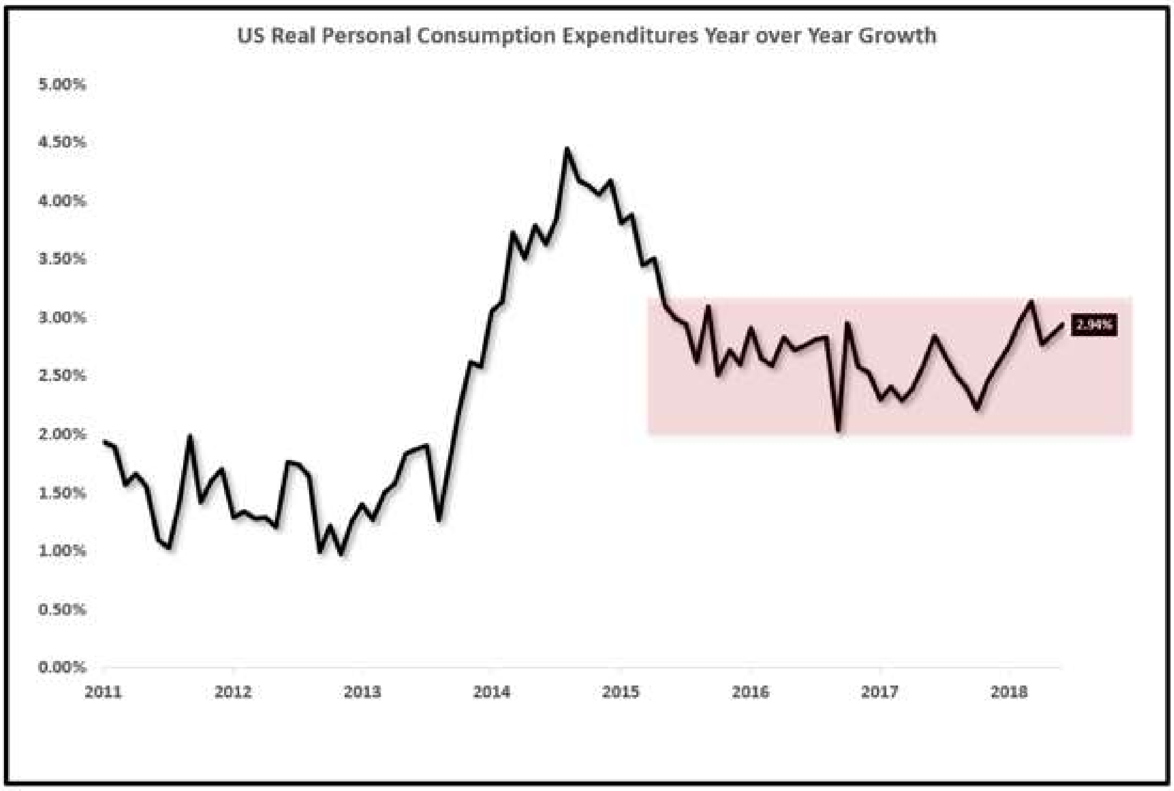
First, real personal consumption growth is 70% of the entire economy. The metric below represents the growth rate for over 2/3 of the entire economy, and there is an interesting trend to note. From 2015 through today, 70% of the economy has grown at the same speed. There has been no acceleration in real consumption growth.

While consumption growth has been flat, real GDP growth in year-over-year terms moved from a low of 1.3% in 2016 to a high of 3.04% in 2018. How did the growth rate of the economy move from 1.3% to 3.0% while 70% remained flat?

The evidence indicates that a majority of the acceleration in GDP growth was a result of government spending, inventory building, and net exports ahead of tariffs.

This suggests the Federal Reserve was tightening monetary policy into an economy that was not nearly as strong as the headline figures suggested.

Real Personal Consumption Growth:



Source: BEA, EPB Macro Research

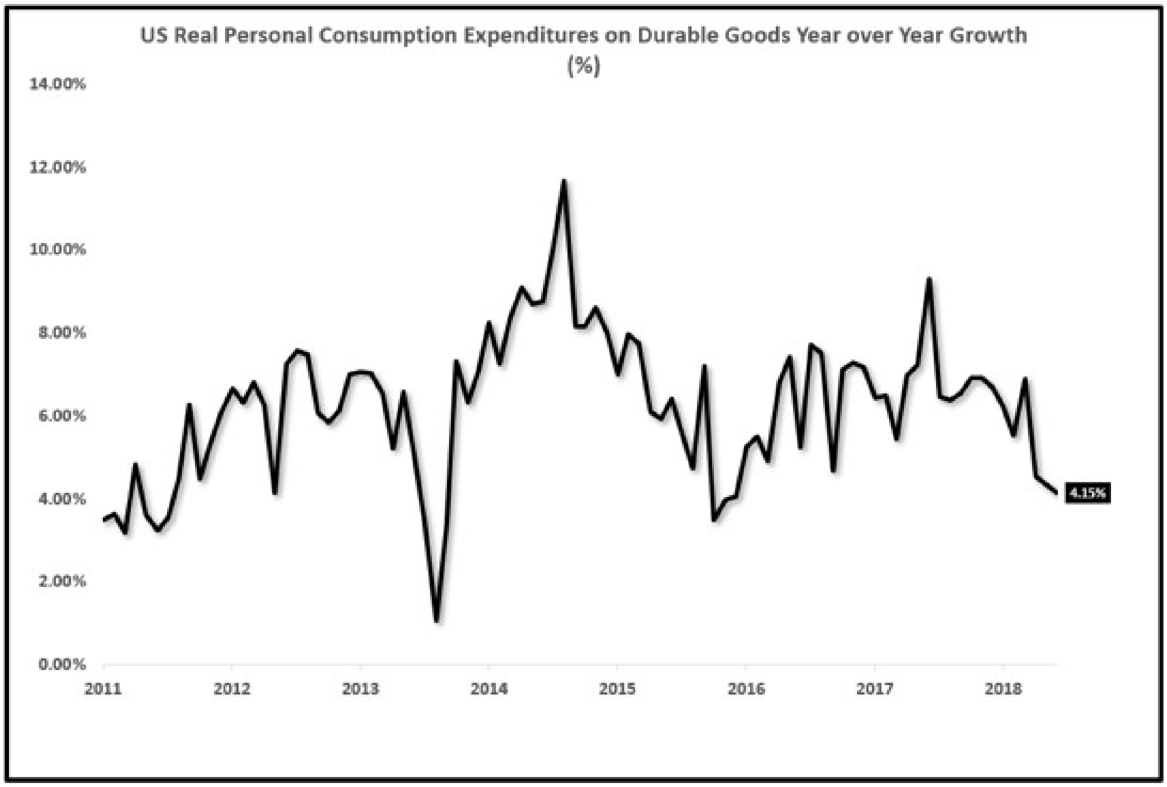
In 2016, real GDP was 1.3%, oil was moving below $30 per barrel, and there were fears of recession left and right. Today, or at least a few months ago, when the S&P 500 was making a new high, people were claiming that the economy (and the consumer) was the strongest ever with the exact same level of consumption growth.

30% of the economy drove the marginal changes in growth that allowed equity investors and the Federal Reserve to get far more bullish than the underlying economy should have allowed.

Looking at a sub-component of personal consumption, durable goods consumption, which includes big-ticket items such as home appliances, has decelerated sharply and is near the 2016 lows when, again, recession fears were heard loud.

Durable goods consumption is a leading indicator of the economy and broader consumption as consumers pull back on big-ticket items first before less discretionary spending such as healthcare, captured in the headline consumption metrics.

Real Personal Consumption Growth: Durable Goods Only:



Source: BEA, EPB Macro Research

The underlying economy did not accelerate much from 2016 through the present with the exception of inventory gains and government spending.

There was an increase in business investment, but that was concentrated mostly in the oil patch and a result of the price of oil moving from $30 to $70 over the course of those two years.

Equity investors pushed the S&P 500 far above where the fundamentals of the economy suggested were appropriate and allowed the Federal Reserve to tighten monetary policy too much.

Given that monetary policy works with a lag, we are just now feeling the effects of a slowing economy as a result of monetary tightening and the equity market is suffering, led lower by bank stocks.

Summary - What To Do

Given the indebtedness of the economy, public, and private, the pace of monetary tightening was far more aggressive than most investors realized. The impacts can be seen in the rate of deceleration in bank credit, bank assets, money supply, and the yield curve.

Given that monetary policy works with a lag, the impact was not seen immediately, allowing the S&P 500 to rise rapidly.

The surge in stock prices made the Federal Reserve tighten policy even more aggressively which we can empirically see is starting to slow the economy.

Even if the Federal Reserve stops tightening policy now, the effects of 2018 tightening are still going to ripple through the economy as the underlying economic conditions are much weaker than headline GDP suggests.

The market is responding to a slowing economy, not trade wars or hush money payments; those are sideshows.

Economic growth will continue to decelerate which should cause more volatility in the stock market.

What I have been telling members of *EPB Macro Research* since the summer of this year is to position for an environment in which growth and inflation are both decelerating. At *EPB Macro Research*, such an environment calls for an increased allocation to cash, an overweight position in defensive sectors such as utilities (XLU), a position in long-term bonds with the expectation of lower rates, and to avoid or short high growth, high momentum sectors such as technology (QQQ) (XLK) and bank stocks (KRE).

This positioning has resulted in a dramatic outperformance, so far, in Q4.

The Federal Reserve has pushed monetary policy too far. It makes sense that the market is rapidly pricing out future monetary tightening. There is a high probability that if the Fed raises rates in December, this will be the last hike of the economic cycle.

Even if no rate hike occurs, balance sheet reductions will still be running in the background, reducing excess reserves, putting further strain on the banking sector and perpetuating a deceleration in economic growth.

The Federal Reserve has already pushed too far.

Risk Management & Portfolio Allocation Strategy

EPB Macro Research uses macroeconomic data to identify inflection points in the economy and provides two asset allocation models that are best suited for the current environment so that your portfolio is **always protected from the next downturn.**