Executive Summary

January 2020

After a large decline in markets during the last quarter of 2018, including the worst December since the Great Depression, we had a major reversal in 2019 with most of the credit for this being attributed to the Federal Reserve. The Fed, after seeing how damaging its hawkish policies were to markets in the fourth quarter of 2018, reversed course with its interest rate policy in 2019 by aggressively cutting interest rates. To boot, it poured even more monetary fuel into the economy via additional quantitative easing (even though they don't call it that) starting in September 2019. Since late 2019, the Fed has pumped more than $500 billion into short term monetary markets. The media has been describing this as "activities in the Repo Markets". The question is, why is this happening if all is wonderful with the economy?

While this has extended the life of the bull market, it has also made the stock market bubble of the last few years even more dangerous. Looking back in history, the two major stock market bubbles of the last thirty years that resulted in crashes were caused by the Federal Reserve providing excessive monetary fuel at times when markets did not need it. These periods were 1998-2000 and 2006-2008. When and how our current bubble ends is still unknown. What we do know is that stock market valuations are at their highest in history, and corporate earnings growth was flat for the S&P 500 in 2019. In the meantime, the S&P 500 index was up 35%. Why? Price-earnings expansion accounts for a good part of the move. It means paying more for the same fundamentally valued share of stock than in prior periods. There are no signs of recession yet. By the time a recession is officially declared, the economy is usually six months into it already. Markets are unbelievably passive considering their history over the last century. For the most part, overall market valuations in the United States are above the 90-95th percentile. Corporate debt, fueled by easy money from the Federal Reserve and low interest rates, is at record levels and much of it has been used to repurchase company stock, which reduces the supply of stock, thereby increasing share prices.

The question of the day is whether interest rates stay low to allow for continued stable markets or will there be some trigger to increase market volatility? The stock market is a confidence game. Markets need to have confidence that global central banks know what they're doing and have control of monetary supply. Of course, economic fundamentals are important, but the economy does not have to correlate with the stock market. The world's major central banks, including ours, have pumped up the monetary supply to levels never seen before. So far, it's worked. It's important to understand that the stock market bubbles mentioned above were caused by aggressively ramping up monetary supply. In normal times, we'd have some inflation. These are not normal times. The Federal Reserve's revised stated goal this year is to get higher inflation into our economy. Some early signs indicate that they may succeed. Higher inflation leads to higher commodity prices and eventually to higher interest rates. Ten-year rates on Treasury notes above 2.5%-3.0% could cause a serious problem for many companies that have gorged themselves on corporate debt. Currently, rates are right around 1.7%.

Some of this excess liquidity has now started pouring into emerging markets, commodities, and small caps. However, as before, a good part of the excess liquidity is finding its way into the most speculative elements of markets much like in the period from 1998 to 2000. We know how that ended, but what will it be this time? A surprise increase in interest rates, perhaps relating to some problem in the Repo market? The bond market losing confidence in the Federal Reserve? Or, will it be some global issue that finally becomes the trigger to end it?

Markets always revert to the mean. From what levels and over what time period are the unknowns. Markets can revert over the next ten years in one of two ways. They can have substantial corrections along the way similar to the last quarter of 2018 or there can be a full blown bear market in a one to two year period that takes the markets down 55%-75%. Right now, it appears the S&P 500 index needs to go down about 11%-12% from last week's levels before serious warning signals appear.

For now, a balanced allocation with a larger than average allocation to interest bearing cash instruments is warranted.