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BLOG POST

Does the 'Fed Put' Still Exist?

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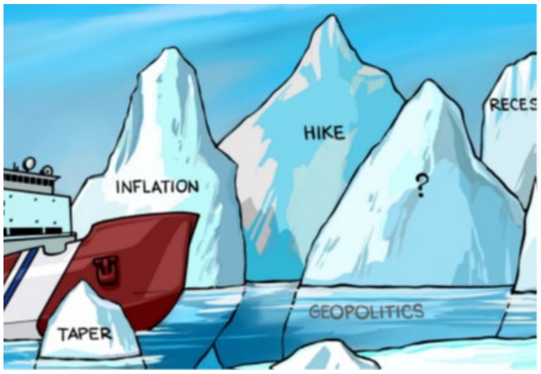
Events have moved quickly in late February with Russia launching a full-scale invasion of neighboring Ukraine, creating global upheaval. Equities had just barely moved into correction territory, defined as down 10%, when Russia launched its attack. Dow Futures dropped almost 1,000 points on the news and investors pulled their belts low and tight expecting a bumpy ride only to see virtually all losses reversed by closing. I do not believe many investors are naïve enough to think we are out of the woods in terms of volatility and drawdown.

As the world digests Russian aggression, many are wondering if the rhetorical Fed Put will save the day for those long in the stock market. In past periods of high uncertainty and volatility, the Fed has stepped in to take actions to support the stock market and mitigate potential losses by investors. We are in a very different environment today with inflation at multi-decade highs, interest rates still near 0%, and the Fed in a quandary. The US Federal Reserve has very dangerous waters to navigate and the events unfolding in Ukraine only complicate their task.

Virtually everyone understands that the Fed has two mandates: maintain stable prices (manage inflation) and full employment. The Fed is not charged with protecting stock market investors from losses but has often used rate-setting policies to accomplish just that. Their rationale has been the 'wealth effect'. If consumers' investments and 401k accounts fall precipitously, they are not in a mood to spend, negatively impacting economic growth. With the Fed so far behind the inflation curve with respect to policy, any Fed backstop for investors seems unlikely at best.

Geopolitical events are not helping the mood of investors, but historically these events have had a very muted impact on markets, especially when the events are far from home (expect much more of an impact in Europe). Most concerning to many investors is the fact that the markets had corrected 10% before the Fed even announced its first rate hike. The adage, "Don't Fight the Fed" has historically been good advice, and the Fed is clearly intent on tightening monetary policy.



The data on stock market corrections over the last 25 years might surprise some readers. When the S&P 500 dropped 10% or more, this typically resulted in strong returns over the following 12 months. In fact, two-thirds of the time when the S&P hit correction territory it was positive over the next year. The average return in the year following a correction is +9.3% according to S&P data, so bear markets do not always follow a correction.

There are also signs that suggest markets may rebound as quickly as they corrected. The COVID-related restrictions that have negatively impacted the economy for two years are mostly being lifted, suggesting economic activity may return to some level of normalcy. It also appears that while stimulus is being withdrawn in the U.S. with the end of quantitative easing, new rounds of stimulus are set to begin in China, potentially fueling higher global economic growth.

It is a lot for investors and portfolio managers to digest as they attempt to position for the uncertainty of the future. Recency bias has led many to 'buy the dips' as even sharp drawdowns have been followed by V-shaped recoveries (think April 2020). The time will come when investors have to navigate a very different recovery path. Let's not forget that the Nasdaq today is still down more than 50% from the high set in early 2000. More recently, the S&P 500 hit a high in October 2007 and did not get back to the same level until April 2013, almost 6 years to recover the losses caused by the GFC (global financial crisis). Perhaps the most alarming example, the Dow Jones hit 1,000 for the first time in 1966 before experiencing a correction. It was not until 1982, some 16 years later, that the index surpassed 1,000 again.

What should investors be doing today? Avoid becoming myopic with events taking place. If you only focus on the negative, or positive, your perspective becomes skewed and you lose the ability to balance risk and return in decision making. Be aware of your assumptions. Don't assume that because the last several corrections were buying opportunities that every correction is a buying opportunity. Sometimes recovery from drawdowns can take years, or even decades to recover from. Understand what you are relying on. The Fed may have saved the day in the past, but it may take a well-diversified and tactical approach to navigate the waters that we currently face.