

The Stock Market and the Federal Reserve

If you want to improve your returns in the stock market, we believe you should pay close attention to what the Federal Reserve is doing because **liquidity moves markets**. Doing so will do wonders for your wealth.

Unfortunately, when it comes to the stock market, a majority of investors underperform in good markets and challenging ones because they fail to focus on the most important factors.

Since the financial crisis a decade ago, the U.S. stock market has gone down, but it has yet to stay down. A major reason for that is the Federal Reserve and the supply of money.

The Fed's playbook is based on what we refer to as the Bernanke doctrine, as former Fed Chairman Ben Bernanke is the architect of current Fed policy. Mr. Bernanke believes that the stock market is the engine that can generate a wealth effect and increase consumer spending.

Mr. Bernanke said as much in his November 4, 2010 Op-ed in the Washington Post highlighting the benefits of Quantitative Easing ("QE"), the asset purchase program put in place following the 2008 financial crisis. He wrote, "And **higher stock** prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous cycle, will further support economic expansion."¹ (Emphasis added)

The basis of this philosophy was laid out well before the "great recession" of 2008. Back in 2002, Ben Bernanke said, "**if a sudden correction in asset prices does occur, the Fed's first responsibility is to protect...to provide ample liquidity until the crisis has passed.**"² In 2011, Bernanke told Congress that "asset purchases appeared to be successful in...**raising the price of equities** and other assets."³ (emphasis added)

In late March 2020, the economy was hit by the COVID-19 pandemic, which caused an unprecedented shutdown of schools and businesses across the country and wreaked havoc on the stock market. The Federal Reserve, led by Chairman Jerome Powell, went into action by pumping a massive amount of money into the markets in order to fulfill its mandate of "maximum employment and stable prices."⁴

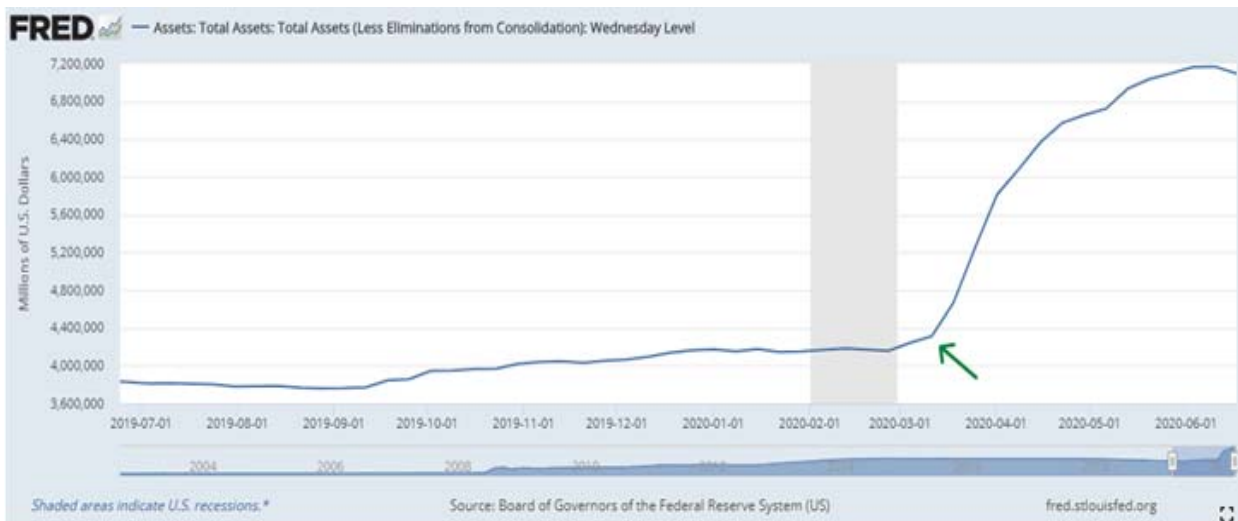
In a rare morning interview on the NBC Today Show, Chair Powell confirmed that the Fed was prepared to spend an "unprecedented" amount.⁵ As you can see in the adjacent chart of the Federal Reserve's assets, the term "unprecedented" was an understatement.

Between mid-March and early June, the Fed increased the size of its balance sheet from roughly \$4.2 trillion to almost \$7.1 trillion. A \$2.9 trillion expansion – roughly a 67 percent increase - in less than three months. To put that amount of money into perspective, the Powell



Fed “printed” as much money in 12 weeks as it took the Ben Bernanke-led Fed to “print” in five years following the 2008 financial crisis.

That is because soon after leaving the Federal Reserve, Ben Bernanke said, "Although we have been very aggressive, I think on the monetary policy front we could have been even more aggressive."⁶ So the Powell Fed learned that when you have a crisis, you should go big early rather than have several rounds of QE.



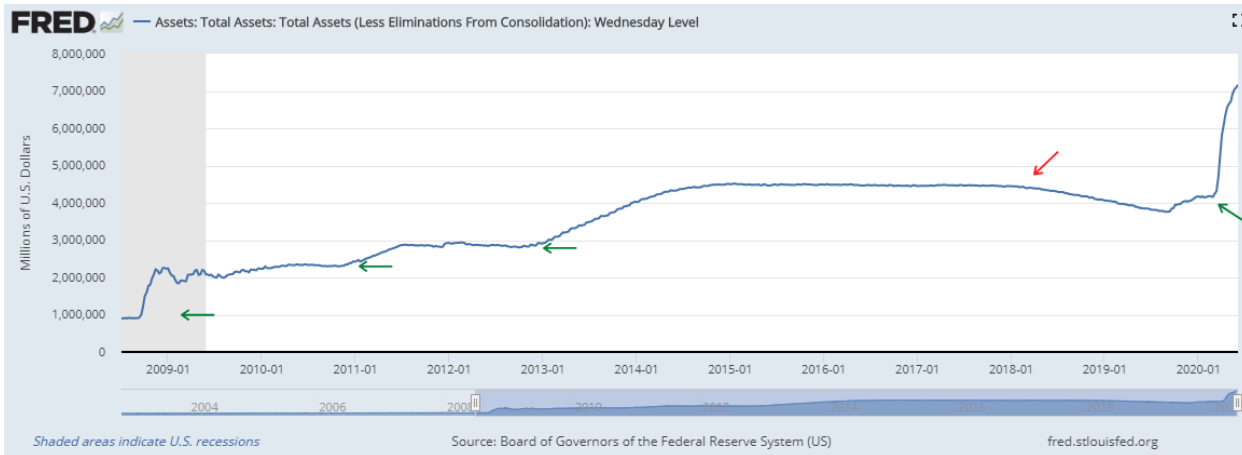
For those that have studied the influence that monetary policy has on the stock market, it should come as no surprise that the S&P 500 index rallied more than 40 percent from late March to early June. In fact, from the Fed’s March 23, 2020 announcement of new monetary “facilities” until early June, every single stock in the S&P 500 index had a positive return.

The Bernanke Doctrine

Ben Bernanke, a student of the Great Depression, believes that the government should have done more to offset the contraction in the economy. In a 2002 speech titled “Deflation: Making Sure “It” Doesn’t Happen Here” - he said, “the U.S. government has a technology called a printing press (or, today its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost.”⁷

Clearly the Fed has taken a more active role in trying to manage the economy with a keen eye on asset prices. In a 2017 speech titled “Monetary Policy in a New Era,” Ben Bernanke said “There is no doubt that monetary policy affects the prices of stocks and other assets...Those affects are an important vehicle of monetary transmission.”⁸

A look at the Fed's balance sheet since 2008 will show that the Fed has periodically responded to weakness in the economy or volatility in the markets with a surge of money, and each time the stock markets have responded favorably.



The Dodd-Frank Act

The 2008 financial crisis left the Federal Reserve without the tools necessary to deal with large financial institutions that were under great stress. As a result, the Dodd-Frank Act was passed in 2010. It gave the Fed new responsibilities including “the responsibility to track and respond to possible risks to the financial system.”⁹

Transcripts of Federal Open Market Committee meetings are released after a 5-year lag. In the October 2012 minutes of the Federal Open Market Committee (FOMC) meeting – released in late 2017, Jerome Powell said “Investors really do understand now that we will be there to prevent serious losses.”¹⁰

Looking back, it seems like that position was tested on August 24, 2015, when the Dow Jones Industrial Average fell by more than 1000 points, or 6.6 percent. As volatility spiked, former Fed Vice Chairman Stanley Fischer said he thought things “could settle fairly quickly.” Over the next few weeks, the markets did calm down.

Regarding those October 2012 FOMC transcripts - released in late 2017 - Jerome Powell referenced the Fed's “short volatility positions.”¹¹ It's clear that in 2015 Stanley Fischer knew the Fed was buying securities intended to dampen volatility, which very few investors were aware of at that time.

What It Means To Investors

Clearly, the Fed's tool kit has incorporated a host of new securities since Dodd-Frank was enacted. In a speech titled "When Growth is Not Enough," Ben Bernanke said "some active interventions thus seem a necessary part of a responsive policy mix."¹²

Since March 2020, the Fed has "intervened" by purchasing corporate bonds and exchange traded funds (ETFs) for the first time in history. In fact, as of June 18, 2020, the Fed had purchase more than \$6.8 billion of ETFs, including junk bonds, to support the markets and the economy.

Over the past decade a number of senior Fed officials have given hints that market participants need to understand. For example, Former Fed Chair Janet Yellen spoke of "Automatic stabilizers," and Jerome Powell has repeatedly said the Fed will "act as appropriate to support continued growth" and "provide insurance against ongoing risks."

Therefore, while the Fed is not infallible – they missed the tech bubble in 2000 and the subprime crisis in 2008 – they are taking a more active role in the markets. Although volatility is unlikely to go away, the opportunities in the markets are as great as ever. If you have not done as well as you could have, it's time to ignore the headlines, opinions, narratives, and predictions, and focus on the things that really matter.

Being on the same side as the Fed can help you optimize your returns.

Please feel free to pass this along to friends or family.

¹ Chairman Ben Bernanke Op-ed column for The Washington Post Aiding the Economy: What the Fed Did and Why, November 5, 2010

²Remarks by Governor Ben S. Bernanke Before the New York Chapter of the National Association for Business Economics, New York, New York October 15, 2002

³Ben Bernanke January 7, 2011 before the Committee on the Budget U.S. Senate

⁴ Transcript of Chair Powell's Press Conference June 10, 2020

⁵ Today Show Interview March 26, 2020

⁶ Ben Bernanke National Bank of Abu Dhabi Conference March 4, 2014

⁷ Deflation: Making Sure "It" Doesn't Happen Here November 21, 2002

⁸ Monetary Policy in a New Era October 2, 2017

⁹The Federal Reserve and the Financial Crisis. The Aftermath of the Crisis p. 42

¹⁰Minutes of the Federal Open Market Committee on October 23-24, 2012

¹¹Ibid P. 193

¹² When Growth is Not Enough June 26, 2017