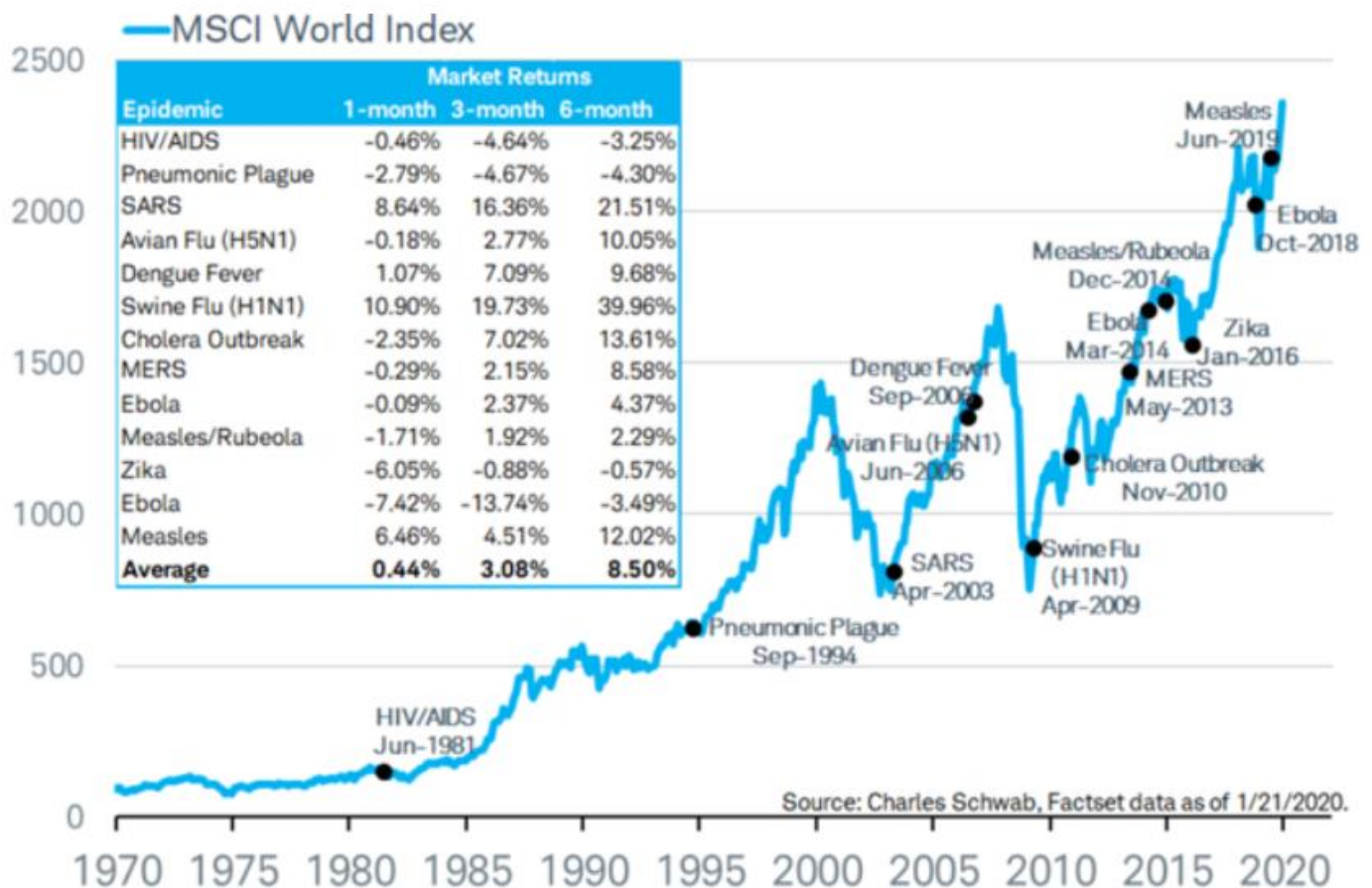


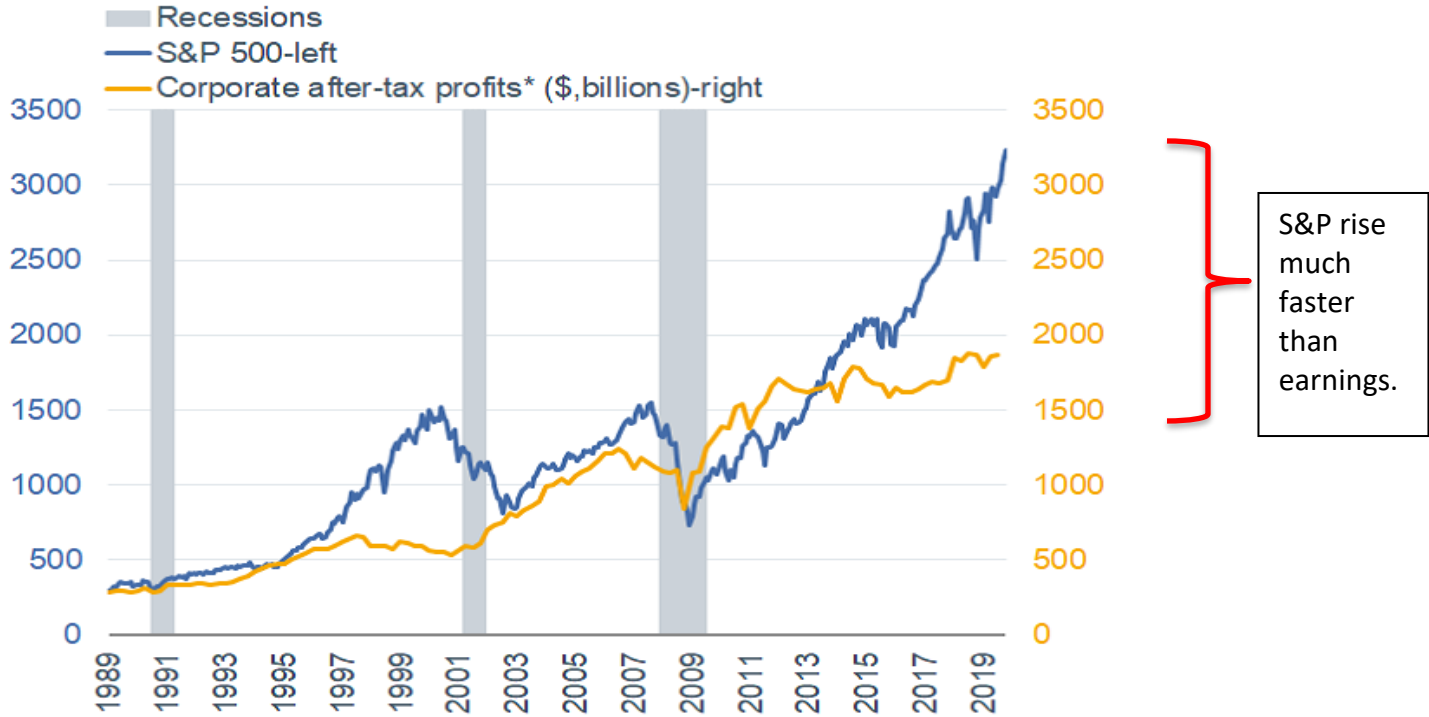
Market Insight: Has the Bull Caught a Virus?

The streak of five consecutive months of gains for the S&P 500 was finally broken on Friday with the S&P index closing down -0.15% for the month of January. Until a week ago, the market rise seemed unstoppable: earnings were better than expected (slightly positive instead of negative), trade tensions have eased, credit is cheap, and the prospects for global growth had marginally improved. Some of the key fundamentals for the market were slightly positive prompting investors to become quite exuberant, valuations to be stretched and created a perfect setup for a negative surprise. Nobody was expecting a virus to infect the bull market. Now with the unknown effect on global commerce, the Coronavirus is raising concerns that the ‘symptoms’ of a recession will reappear. This possibility has put the Bull market in quarantine, at least for now. Will the market shake this off and resume its upward trend or is there more downside to be expected?

Perspective: Although the stock market has dropped about 3% off record highs, history shows the market has been relatively immune to viral epidemics. The chart below, by Charles Schwab, shows stock market performance and world epidemics. **Notice the brief dip in stocks and then a continuation of the uptrend. Is this time any different? Probably not, but for very different reasons.**



Until the Coronavirus appeared, the market had been on a near vertical ascent since early October. During this time, though some of the market fundamentals had been improving, there were just as many or more economic measurements (including corporate earnings) that have remained quite weak and really do not support the case for higher stock prices. This divergence in prices and fundamentals can be explicitly seen in the two charts below. The first chart shows the widening gap between the S&P 500 and Corporate profits, and the second chart shows a rising P/E ratio.



Source Charles Schwab

Price-to- Earnings Inflation: P/E Ratio at 18.7, highest since May 2002.



Source: Factset

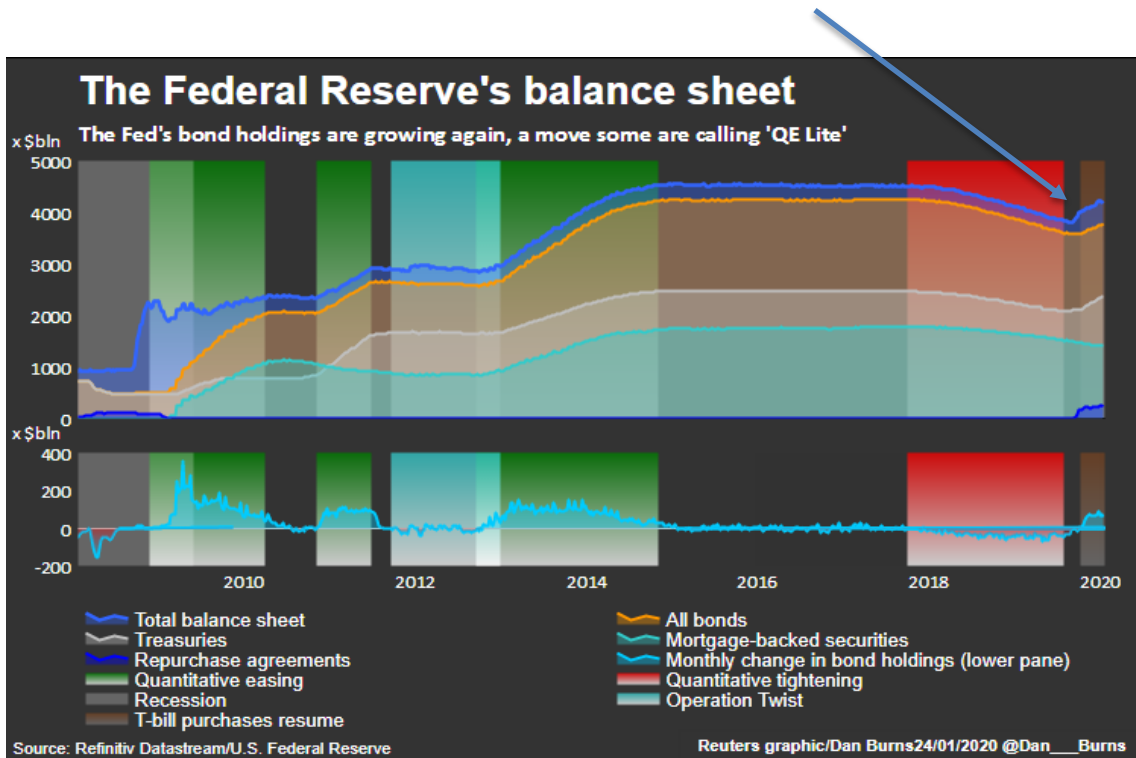
So why has the market continued to push higher despite high valuations and tepid fundamentals? Easy Money provided by the Fed through two modes: lower rates and Quantitative Easing Lite (QEL). During 2019, the markets enjoyed a major Fed policy shift from tightening to easing. This shift stoked all financial assets. After three rate cuts, the Fed stated they were on hold. But in fact, they continued their ‘easy’ policy by initiating a new asset buying program to ‘reduce’ tensions growing in the Repo and Fed Funds markets. (These two markets are used for short term financing of securities by Banks and financial underwriters and are a vital source of liquidity for the financial markets.)

Starting in early October, the Fed began buying \$60 billion of securities per month and has pledged to continue to do so through April. Coincidentally, the S&P has risen by over 10% during this time. Buying securities (QEL) is in effect another form of easing; however, economist and Fed members disagree on the market impact. Here is an excerpt from Reuter’s Business News by Jonnelle Marte:

“The Federal Reserve’s bond portfolio is swelling again at a pace not seen since the “quantitative easing” heyday in the early 2010s.... Prices for stocks and other risky assets are also rising at a fast clip - a state of affairs that a growing chorus of investors, economists and former Fed officials say is no coincidence, and potentially a problem... “

*“In the wake of the financial crisis of 2007-2009, the central bank acquired a vast portfolio of Treasuries and mortgage-backed securities - topping \$4.5 trillion at its peak - through three operations known as quantitative easing, or QE. While designed to help lift the economy after the crisis by holding down long-term interest rates, **QE also had a side-effect that appears to be replaying now: Prices for risky assets like stocks and low-quality corporate bonds rose as the Fed’s portfolio grew.**”*

The chart below shows the Federal Reserve’s Balance sheet since 2008 (blue line) and the periods of Quantitative Easing (Green shade). Notice the blue line declines in 2018 which when the Fed was tightening (coincidentally the markets declined). Since mid-2019, the balance sheet has been growing and is back to near its previous high (coincidentally the markets have once again been on a rapid ascent).



Coincidence? It is hard not to draw a relationship between the Fed action and the stock market. The S&P rose roughly 37% during both QE1 and QE3, and by 10% under QE2. And since the new asset buying program in October, the market has gone virtually straight up. Many economists and some Fed members agree their actions could be fueling excessive valuation; others, including Chairman Powell and Minneapolis Fed President Kashkari disagree. Regardless of opinion, the market will speak for itself; and if the last ten years are used as evidence, a strong argument can be made not to fight the Fed actions. But be sure this debate will continue for decades to come.

In the meantime, what to expect: The economic conditions are mediocre at best. Global manufacturing is in a recession, and likely to be dragged further down as the impact of the Coronavirus permeates throughout industrial sectors. But the consumer is very healthy and continues to solidly contribute to GDP. And with low rates and the Fed continuing its QEL mode, the 'support net' remains under the market. However, the markets could be in 'quarantine' (stall) mode for a while, which would be a good thing because valuations have become quite stretched. Net, it may take some time before the markets feel healthy again, but as long as the Fed remains friendly, the odds are in that direction.

Investment Strategy: Although the stock/bond allocation remains the same, risk was increased slightly late in the fourth quarter through rotating some exposure out of defensive sectors and into growth sectors. But overall, risk remains in the "Neutral" zone. Bond duration remains moderate with an overweight exposure to high credit quality bond sectors.

As always, please contact me with questions or concerns. These are my thoughts. Your feedback is always appreciated.

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