## STOCKS HIT THE GROUND RUNNING IN 2019 WITH STRONG EARNINGS AND POSITIVE FED GUIDANCE

- The rally that began in the final days of 2018 extended through January, pushing the global equity market to its highest calendar-month return in more than seven years.
- Up 8.0%, the S&P 500 posted its best January since 1987, while mid- and small-cap stocks both notched double-digit returns for the month.
- A declining dollar propelled international stocks higher, with both developed and emerging market equities making significant gains.
- All market sectors were higher in January, with Industrials (led by GE) and Energy (led by higher oil) at the front of the pack.
- Strong earnings reports were another catalyst pushing stocks higher. Of the 203 S&P 500 companies that reported earnings in January, 144 beat estimates by an average of 6.5%.
- As markets climbed higher, volatility ebbed lower; the S&P 500 exhibited about half the volatility in January that it did in December.
- From its 2018 low on Christmas Eve through the end of January, the S&P 500 climbed 15% and sits 8% off its all-time high from September 20, 2018.
- The correlation of the S&P 500 to both international equities and the US bond market edged lower in January, helping to further reduce the volatility of diversified portfolios.

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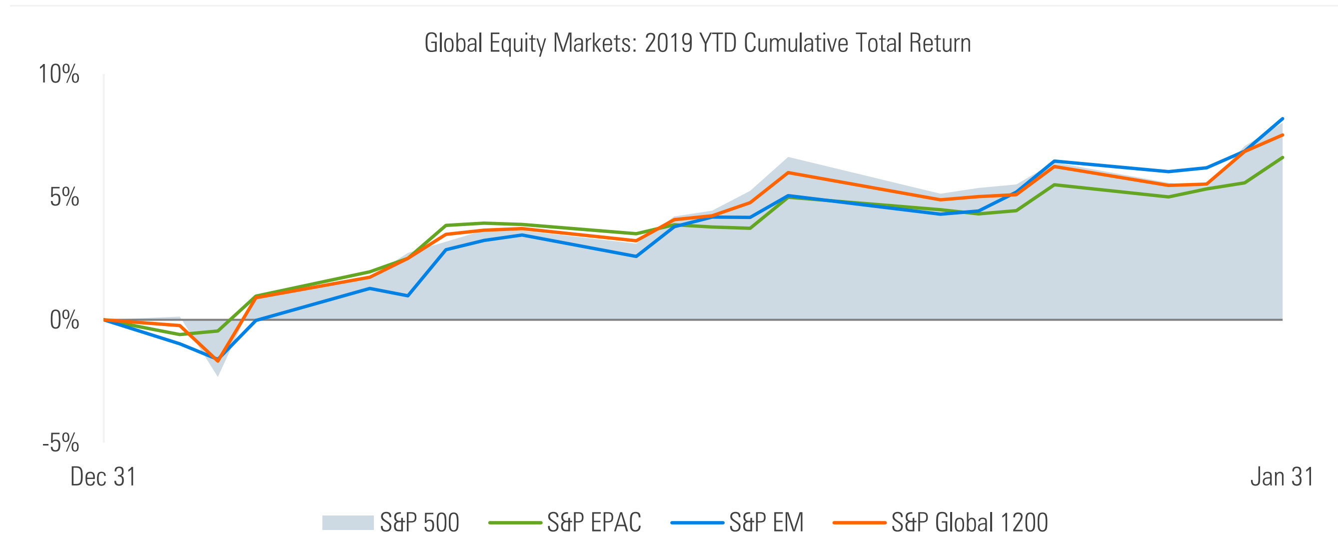


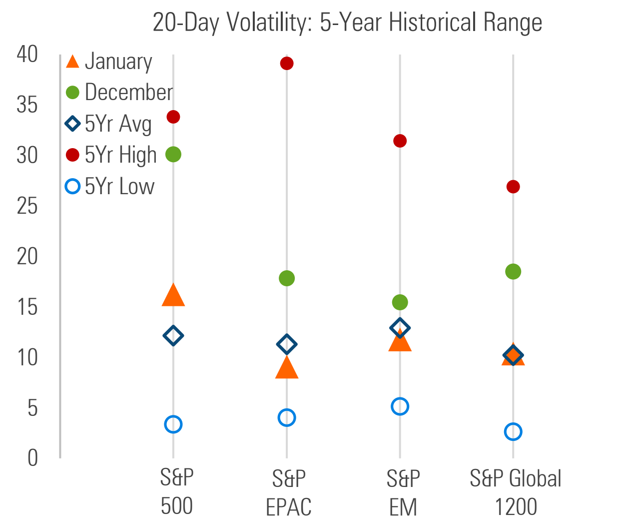


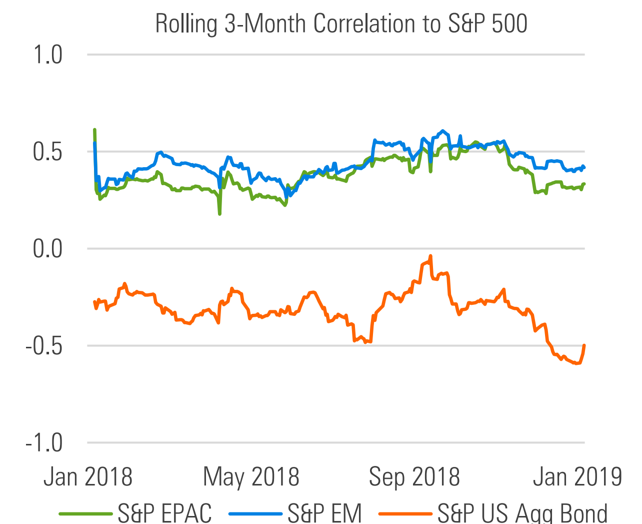

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## MANAGED RISK INVESTING

- Heading into January the volatility of the S&P 500 remained well above the 18% volatility threshold of the S&P 500 Managed Risk Index. The Index began the month with a 47% equity allocation, which climbed gradually to 64% as volatility diminished.
- By virtue of its hedging, exceptionally strong equity market performance and a positive bond market return, the return of the Managed Risk Index trailed that of a 70/30 blend* by 146 bps, but also exhibited just 3/4 of the volatility of the blend and about half the volatility of the S&P 500.
- Over the last 10 years, the Managed Risk Index has exhibited an additional 130 bps of average monthly volatility over a 70/30 blend*, while generating an average excess monthly return of 5 bps, equal to an annualized excess return of 0.61% per year.

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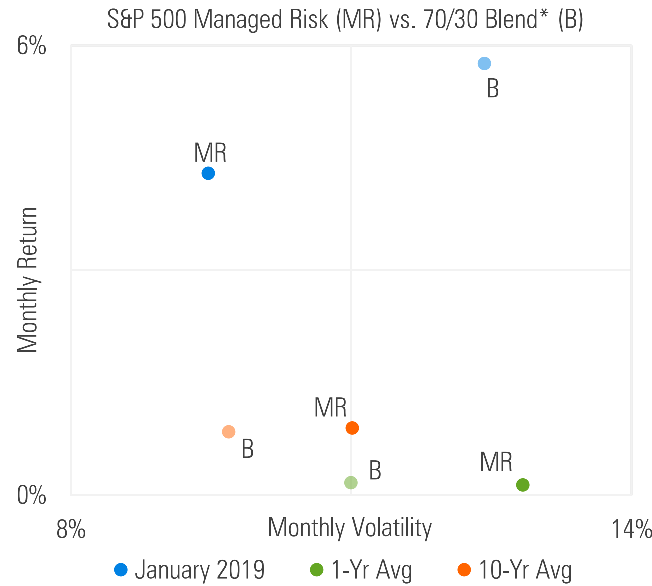
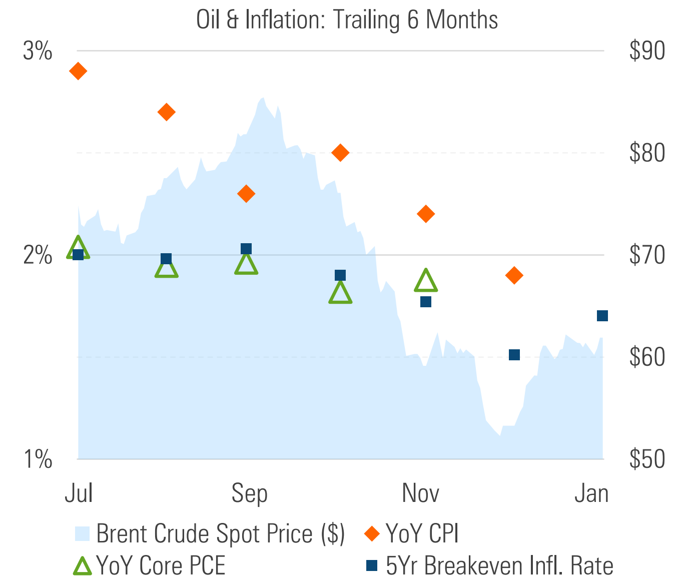
- After touching its 2018 low the day after Christmas, the price of a barrel of oil climbed 18.5% through the end of January, finishing the month at $61.91.
- Year-over-year CPI fell to 1.9% even as 5-yr breakeven inflation climbed 20 bps from its 2018 low to 1.70%. Much of the move came at month end in response to dovish comments from the Fed.
- At month end, the futures- implied probability of a 2019 rate cut was higher than that of a rate hike.

*Measured by the S&P 500 and the S&P U.S. Agg Bond Index




**Total Returns as of January 31, 2019**

| | S&P 500 | S&P 500 MR | S&P 400 | S&P 600 | S&P EPAC | S&P EM | S&P Global 1200 | S&P US AGG | Crude Oil (Brent) | US Dollar | 70/30 Stock/Bond* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 Month | 8.0% | 4.3% | 10.5% | 10.6% | 6.6% | 8.2% | 7.6% | 0.9% | 16.2% | -1.3% | 5.8% |
| 3 Months | 0.3% | -0.9% | 1.0% | -1.3% | 1.5% | 10.3% | 1.1% | 2.9% | -18.6% | -2.4% | 0.8% |
| 6 Months | -3.0% | -3.8% | -6.7% | -10.3% | -7.4% | -2.6% | -4.6% | 2.3% | -17.3% | 0.5% | -1.9% |
| 1 Year | -2.3% | -4.6% | -4.5% | -1.2% | -11.8% | -13.6% | -6.3% | 1.9% | -10.2% | 5.5% | -2.1% |
| 1M Volatility | 16.3% | 8.6% | 15.6% | 17.3% | 9.1% | 11.8% | 10.4% | 2.4% | 31.9% | 5.0% | 12.4% |

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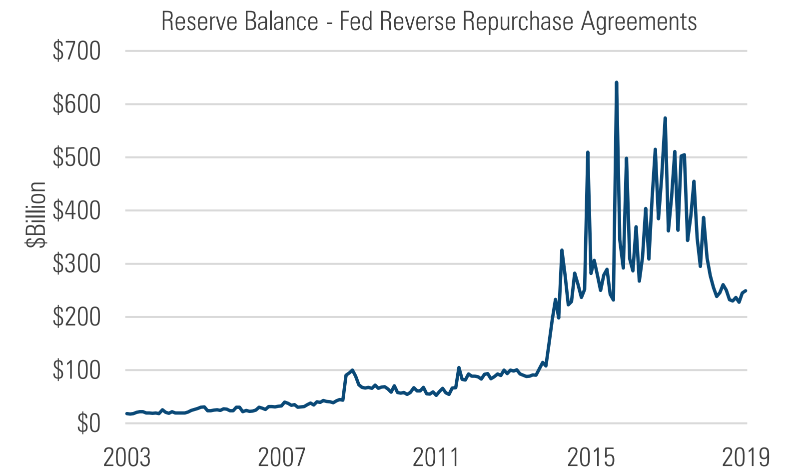
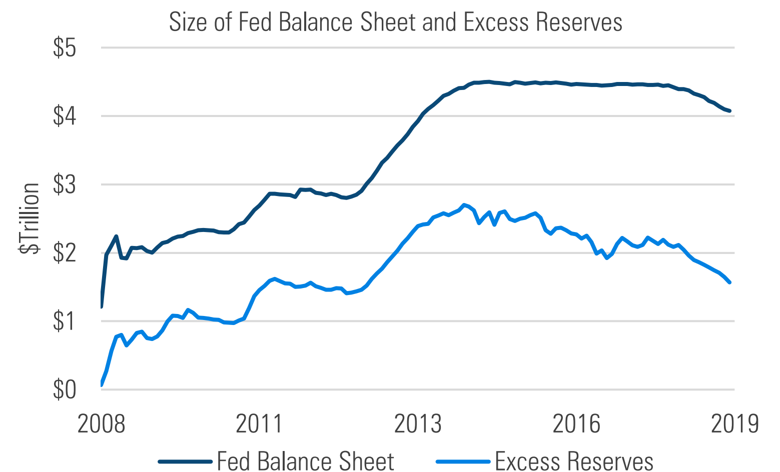
## PARSING POWELL: FED APPEARS INTENT ON MAINTAINING EXCESS RESERVES INDEFINITELY, ALONG WITH ITS LARGER ROLE IN FINANCIAL MARKETS

- Through the expansion of its balance sheet and the creation of excess reserves, the Fed lost its ability to control the fed funds rate via conventional reserve management. This necessitated the Fed's use of the reverse repo market, in which the Fed now transacts with a set of counterparties that is much broader than the relatively short list of primary dealers it conducted traditional open market operations with prior to the financial crisis.
- In a 2015 paper*, Fed economists note that, "The main concern raised by the Federal Open Market Committee in using an overnight reverse repurchase agreement facility is that a large and persistent program could permanently alter patterns of borrowing and lending in repo markets and money markets as a whole."
- During his Jan. 30 press conference, in response to a question about the ultimate size of the balance sheet, Chairman Powell noted, "Remember banks have more reserves than they need. Reserves are still quite abundant…We want to have a buffer because we want to be operating in an abundant reserves regime, where we operate through our administered rates [i.e., interest rate on excess reserves and overnight reverse repo rate]. If you operate too close to that point of scarcity then you wind up having to have these big ongoing interventions in the market. We don't want the Fed to have a large ongoing presence in the market around this, in managing the Fed funds rate. We'd rather have it set by our administered rates."
- Among the many questions posed to Powell, none sought to understand the Fed's motivation behind this. Why does the Fed want to set the fed funds rate via the administered rates, rather than through the pre-crisis method of managing reserves? If excess reserves are the source of the Fed's reliance on the reverse repo market, must not excess reserves be removed from the system in order to end the Fed's reliance on the reverse repo market and to normalize its vastly expanded involvement and influence in money markets?
- Powell's comments suggest that while the Fed is working to normalize its policy stance, it currently has no intention of normalizing its means of policy implementation. Rather than extracting itself from the larger role it took on during the crisis, the Fed seems intent on persisting in it, both through its involvement in the reverse repo market and through the maintenance of excess reserves via a larger balance sheet.
- In the paper mentioned above, the authors also advised readers to, "Keep in mind that the Fed's operations in financial markets before the crisis were generally quite small and were aimed at affecting conditions in the federal funds market, a relatively small market. A large overnight reverse repurchase agreement facility could potentially expand the Federal Reserve's role in financial intermediation and reshape the financial industry over time in ways that are difficult to anticipate in advance."
- While markets responded positively to Powell's comments on policy *stance*, the underlying implications related to policy *methods* may pose other risks down the road that at present are not easily discernable.




*Ihrig, Jane E., et al. "Rewriting Monetary Policy 101: What's the Fed's Preferred Post-Crisis Approach to Raising Interest Rates?" *Journal of Economic Perspectives*, vol. 29, no. 4, 2015, pp. 177–198., doi:10.1257/jep.29.4.177.

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