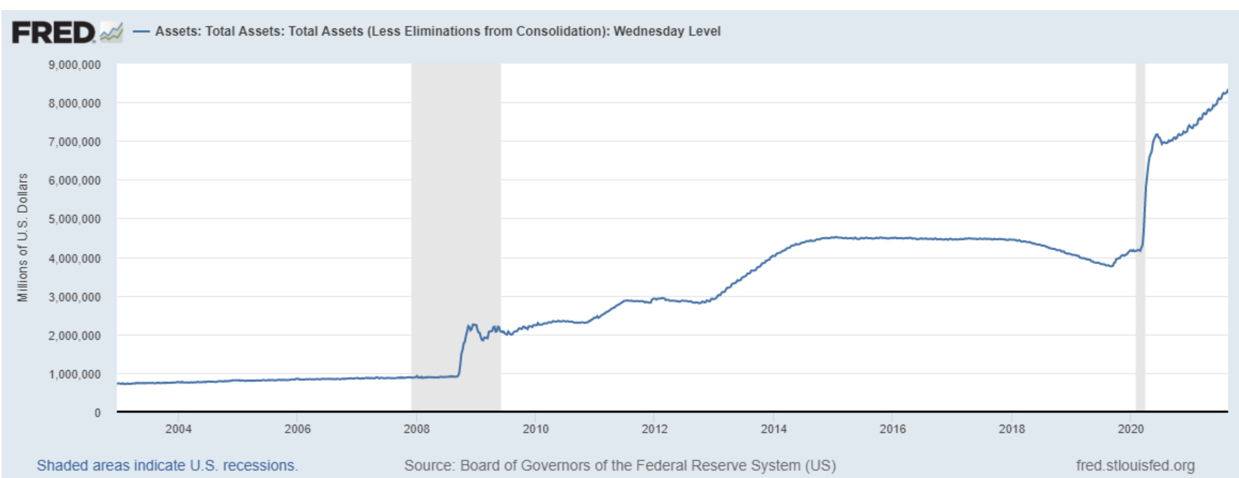
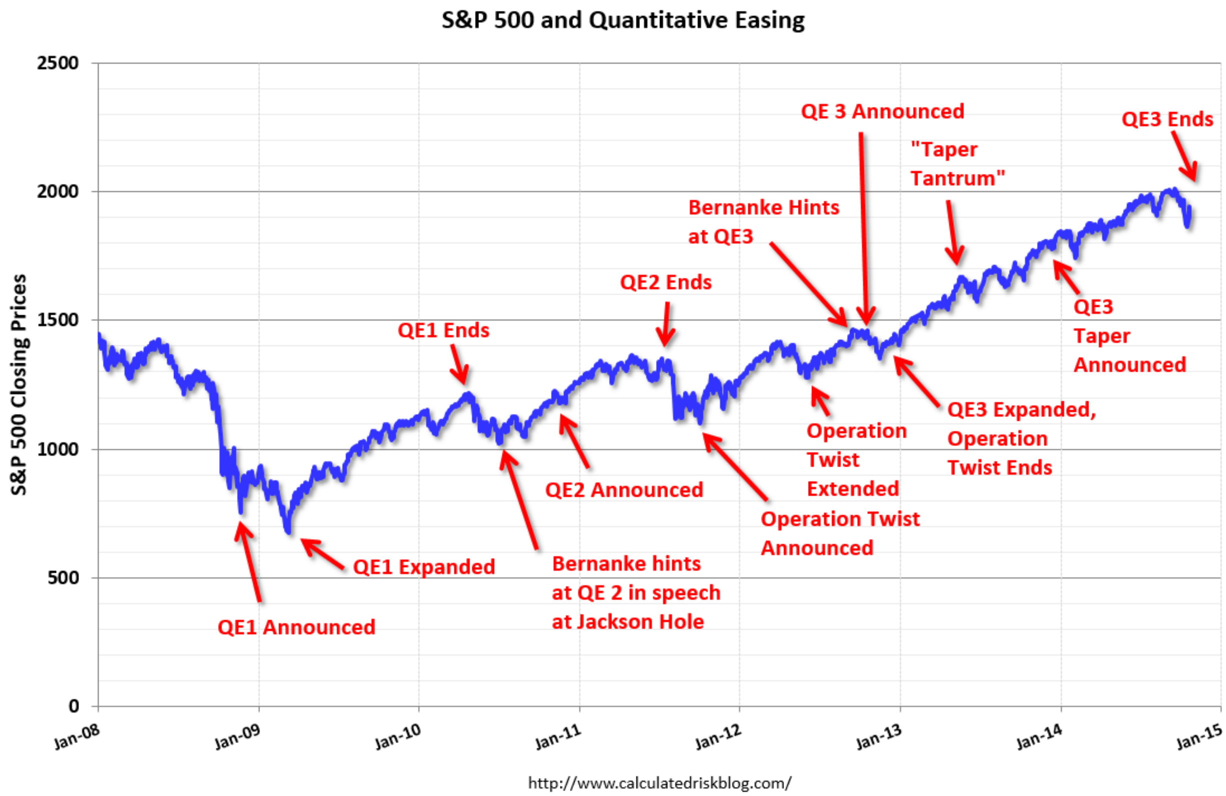
What Keeps Driving the Market?

This is a question we continually get asked when meeting with clients. With everything going on both in this country and around the world, how can the market continue to keep pushing higher? While day-to-day it may be economic news, or an earnings report that helps propel the market higher or lower, overall, we believe the Federal Reserve and its policies continue to drive the market. On March 15th, 2020, the Fed dropped its benchmark interest rate (Fed Funds Rate) to zero. It also began a new quantitative easing program that entailed buying Treasury securities and mortgage-backed securities. Since July 2020, it has been buying $120 billion total each month. With a massive amount of liquidity in the system, and rates at zero, the stock market has continued to make new highs. With banks paying nothing and bond rates remaining low with prices dropping, it has pushed more and more people into the stock market. When factoring in inflation, the stock market has become one of the only places to go to make money. Below you can see the massive increase to the Fed's balance sheet since 2020.



So, the question becomes, “When does the party end?”. As always, we won’t try to predict the market, we’ll react to what our charts and signals tell us. When the Fed does make an announcement of tapering their asset purchases, or raising their benchmark interest rate, the market will have a reaction. The below chart shows previous quantitative easing programs used by the Fed following the great recession of 2008-09 and how the S&P 500 reacted to their beginnings and ends. As you can see, when each one ended, the market reacted negatively. But, they would soon be followed by the next quantitative easing program and the market would rally.



We will see how the market reacts this time to the Fed’s tapering of asset purchases and raising rates. We believe it will be tough for them to walk the tightrope of tightening their monetary policy and not causing disruptions in the market. The timing and pace of the Fed’s stimulus has been and will continue to be a key focus for markets. Fed Chair Jerome Powell will make remarks on Friday August 27th but is not expected to make any taper announcements. Analysts at investment bank Goldman Sachs put the chances of a taper announcement in November at 45%, and an announcement in December at 35%. With COVID now resurging and supply chain disruptions persisting, it may allow the Fed to continue to err on the side of caution and continue to push back its taper announcement. We have also seen many economists lower their GDP estimates for the 3rd quarter this year. Goldman Sachs cut their 3rd quarter estimate almost in half, from 9% to 5.5%.

Current Conditions

Looking at the market currently, it certainly looks healthy. Below shows the S&P 500 (black line) looking back 1 year. The blue line represents the 50-day moving average. That line as you can see has served as support for the market during each pullback since the rally that began last November.

Looking at this chart also shows that we are certainly overdue for a pullback. We have gone almost a full year without seeing the market drop more then 5%, which is unheard of. Just because we're overdue, though, doesn't mean something is imminent. Our strategy is to continue to tilt more risk-on until the 50-day moving average doesn't hold as support. When that line breaks, we would become more cautious. We have taken profits in certain areas the last few months and raised some cash in a few of our portfolios as we've seen some cracks underneath the surface.

Conflicting Signals

One thing we've been watching the last few months is the deterioration in market breadth. While the overall market picture looks healthy when looking at the S&P 500, underneath it doesn't look as healthy. The rally in the market since June has been carried mostly by mega-cap technology companies like Apple, Microsoft, and Google. A lot of areas of the market have not been participating. One way to track this is using the New York Stock Exchange Advance-Decline line. This is calculated by taking the difference between the number of advance and declining stock issues and adding the result to the previous value. Obviously it rises when the number of advances exceed declines and falls when declines are exceeding advances. What you want to see is the advance-decline line confirm market rallies. You can see on the following chart, the advance decline line has been trending down since the end of June. When the market makes a new high, the advance decline has peaked at a lower point. Right now, it's just a divergence. Either the advance decline line is a precursor to the overall market rolling over, or the advance decline line rebounds and begins to confirm the markets next advance.

Another part of the market we've been tracking is the Dow Jones Transportation Average. This follows the transport stocks (trucking, railroad, airline, shipping) and can sometimes be a leading indicator for the market and overall economy. As you can see below, it peaked in early May and has also been trending lower.

It has rallied since early August and has gotten back above its 50-day moving average, so our hope is that it is getting back into an uptrend and will begin confirming the overall market's advance.

While we are seeing conflicting signals, many of our overall short and long-term indicators have remained positive. With that being the case, we have continued giving the market the benefit of the doubt. We'll continue to monitor market conditions, ready to make changes when the market inevitably comes under pressure. Since there seems to be no concern of "risk" in financial markets right now, we believe whatever the event is that causes a rush of investors to the exits is not something currently being discussed or worried about in the financial media. As developments continue to unfold, we'll be closely monitoring our indicators for any sign of a broadening selling base. We remain completely open to any eventuality that the market brings, and we are confident that our indicators will help us to successfully navigate whatever happens. Being proactive, our goal will be to not give back all the gains made in the last year when the rush for the exits does happen.

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