10 January 2020

Financial market outlook and liquidity cycle in 2020

400 billion in cash injections in Q4. Expansion or status quo in 2020? High earnings expectations. Extreme equity valuations. More risks than opportunities.

Key points

- Massive and questionable cash injections in Q4
- 400 billion in new liquidity
- Why has the Fed intervened so massively?
- Dangerous interdependency between markets and monetary policy
- Financial markets gamble on the Fed put
- Can the Fed prevent the speculative bubble it has created from bursting?
- Are there any rational investors left in 2020?
- What is there to fear in the short term if markets depend on liquidity?
- High earnings expectations and extreme valuations

Massive and questionable cash injections in Q4

At the start of 2020, it once again looks like most investors minded the old saying "Don't fight the Fed" in Q4 2019! Clearly, one had to brave the already high risk and valuation levels of financial assets at the end of Q3 to benefit from the positive effects on financial markets of the significant activity undertaken by the Federal Reserve at the end of the year with its massive cash injections.

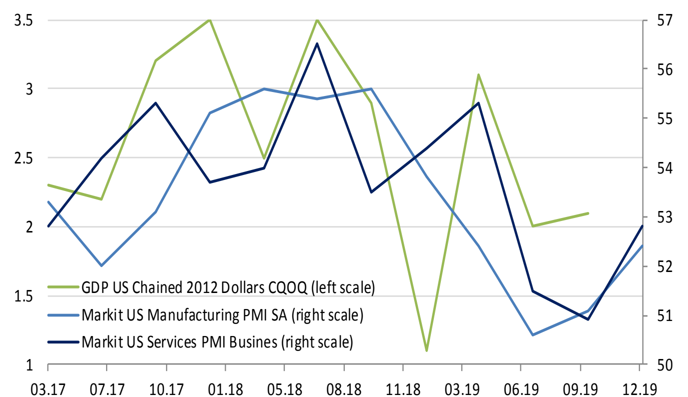
In the last few months, the Fed has indeed relaunched its monetary activity by boosting the size of its balance sheet by more than USD 400 billion in a few weeks, i.e. more than 10% the total size of its balance sheet in record time, from 3.75 (end of August 2019) to 4.17 trillion dollars on 1 January 2020.

The debate consisting in determining whether or not this is a relaunch of QE (quantitative easing) is ultimately of limited interest, since the fact that the Fed has not massively bought Treasury bonds (formal definition of QE) but rather Treasury bills is only a technical matter.

In fact, the central bank has indeed injected an exceptional quantity of cash into the financial system, which at this point in the cycle should actually come as a surprise and raise questions among rational investors.

Indeed, the question arises of why the Fed deemed it necessary, or even essential, to inject such quantities of cash at the end of 2019, when its three -0.25% key rate cuts had certainly been sufficient to support an ultimately not-so-weakening economic situation in Q3 and Q4, with the real need for more QE thus not clearly justified.

US GDP and PMI indicators

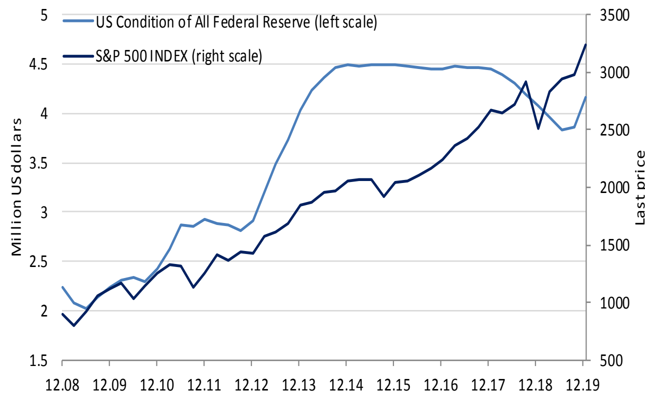


Sources: Bloomberg, BearBull

When these purchase operations began three months ago, one of the reasons invoked had been to ensure liquidity during the tax payment period, especially in mid-October, but these operations then continued until the beginning of 2020.

Moreover, in historical comparison, these 2019 purchases have no equivalent in previous years, enough to wonder about the soundness of the argument.

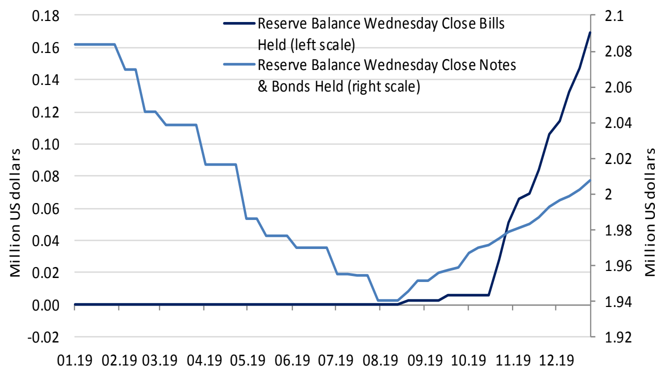
Fed's overall balance sheet / S&P 500 index



Sources: Bloomberg, BearBull

The question thus remains about the real justification of these activities, which actually helped reinitiate a new phase of appreciation in the price of equities and risky assets at the end of the year, while equity valuations were already flirting with historical extremes.

Decomposition between T-bills & T-bonds



Sources: Bloomberg, BearBull

Might there be an issue in the market that the Fed has identified, pushing it to intervene in a state of near panic by providing liquidity that may have already been missing in the financial sector?

The repo market redistributes and provides liquidity essential for the fluidity of the financial system and the smooth flow of short-term trades between financial institutions, banks, insurance companies, etc. The central bank may have aimed to prevent this system, which represents close to a trillion dollars per day, from spinning out or seizing up.

More than ten years on, we still remember the impact in 2008 of how banks instantaneously mistrusted one another, which contributed to the rise of interbank rates and the financial crisis in 2008. Could the end of 2019 have been affected by a similar episode?

Dangerous interdependency between markets and monetary policy

Has the Fed become the hostage of financial markets and vice-versa?

Be that as it may, financial markets have once again welcomed with enthusiasm the monetary injections at the end of 2019, as they actually have every time the economic cycle has been boosted by accommodative monetary policies. There is a very clear correlation between the Fed's actions and movements in equity markets since 2009. Hence, if the Fed has partly become hostage to financial markets, the latter have also become dependent on the Fed's injections.

The current relationship is thus a dependency that works both ways with the growing risks that this entails. The rise in markets depends on the cash injections, which also indirectly aim to create and boost a positive wealth effect to bolster consumption. This interdependency has not been denied by the Fed's former Chair Ben Bernanke, who acknowledged the explicit link when he mentioned that QE was meant to increase the price of financial assets to create a wealth effect favourable to consumption.

The central bank is now faced with a quasi-obligation to maintain an accommodative policy at the risk, if it did not, of once again brutally waking up investors who have become dependent over time. The Fed does not wish to expose itself to such a situation, now that it has experienced the risks of markets slumping, in the event that its normalisation policy were to be perceived as too aggressive, as was the case in Q4 2019.

It has now become a complex issue, of which the Fed is more aware, which is likely to prevent the bank from speeding up any future normalisation attempts. As we have mentioned several times, the Fed will prefer to delay any rate hikes as inflation rises, which will underlie its activity in 2020, an election year, moreover, during which the central bank is generally fairly inactive. The Federal Reserve may thus have hoped to act more massively before 2020 in order to avoid having to act at a later stage during the campaign.

Can the Fed prevent the speculative bubble it has created from bursting?

In an early 2020 context characterised by a weak probability of business fundamentals and earnings prospects improving in comparison with current expectations, the share price increases in the last few weeks are thus exclusively attributable to the rate cuts and monetary policy and have resulted directly in the further expansion of PEs and other market valuation measures.

Hence, the Fed is contributing to the expansion of valuations, or in other words an overvaluation of financial assets, with no real possibility of dampening or limiting this effect. It is thus possible that the Federal Reserve may be realising that it is trapped in an impossible situation in which any normalisation attempt may cause a fall greater than that observed in Q4 2018 and where lack of action may encourage investors to take even more risks and drive market valuation levels higher still.

The longer this spiral lasts, the more likely it will end with the speculative bubble bursting, bubble which has expanded exponentially in the last few months. The growth rate of equity markets in the US is indeed in an acceleration phase characteristic of the end of a financial cycle.

After phases of consolidation and hesitation on already high valuation levels in the summer, the almost +10% increase over two months rests on nothing but the liquidity factor and is thus not supported by fundamental factors.

Hence, it is becoming difficult, if not impossible for the Fed to climb out of this situation without causing the crash that it is seeking to prevent by all means. By slowing its quantitative easing, it risks provoking further undesired market volatility. Yet, it will not be able to continue on this path indefinitely, especially if growth occurs in the first few months and quarters of 2020.

Are there any rational investors left in 2020?

The +10% increase in equities at the end of the year also seems to reflect a total capitulation of rational investors, the saying "Never fight the Fed" having undoubtedly pushed investors' enthusiasm for risky assets to the extreme, seeing as many likely found it unbearable to miss an opportunity to generate gains in a low-rate environment, as the Fed once again seems ready to offer a free "put", encouraging maximum risk-taking.

Private investors are largely invested and optimistic, traders' net long futures positions on most US indices are reaching new heights, the flow of funds into equity funds is once again high and complacency is once again present. Are there any rational investors left or have we all dropped our guard, no longer wanting to consider risks and focusing exclusively on opportunities?

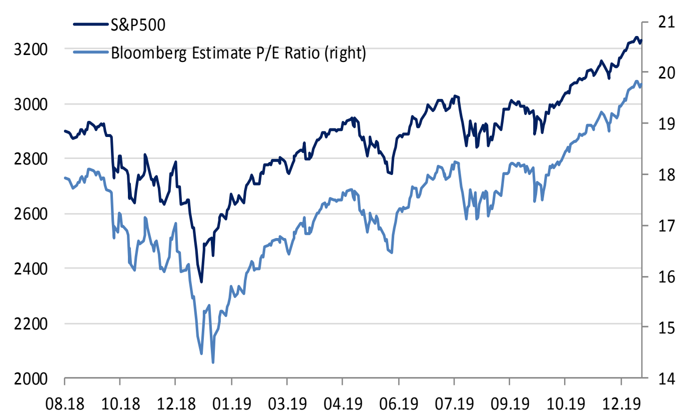
One way of assessing the degree of euphoria of private investors is by looking at the CNN Fear and Greed Index, which has been very close to its maximum of 100 for a few weeks now.

It had reached a high level of greed before the drop in equities in February 2018 and again in September.

However, other more serious measures, fundamental and rational ratios, underline the particularity of the current situation in financial markets and the extreme levels of risk that have now been reached.

Equity valuations are indeed at their highest historical levels according to various measures, which should come as a wake-up call for all rational investors who do not want to see the fate of their investments depend on the Fed's continued quantitative easing only.

S&P 500 & P/E



Sources: Bloomberg, BearBull

As evidence of the extreme irrationality of the current situation, in comparison with the ratios that prevailed 20 years ago, right before the Internet bubble burst, the current valuation of the S&P 500 as measured by the enterprise value to EBITDA ratio has exceeded that which preceded the crash in 2000-2002.

The same goes for the sales to EBITDA ratio. Let us remember that the Fed had then also indirectly driven financial asset valuations upwards by injecting close to 100 billion dollars into the financial system to ward off the unknown potential risks relating to the Y2K issue.

In September 1999 the Fed's balance sheet only stood at USD 567 billion and had only increased by +17% to 668 billion. Liquidity inflated the speculative bubble, which quickly reached record height in the next quarter in 2000 before bursting in a three-year-long bear market that wiped out the previous two years of growth and close to -50% in market capitalisation.

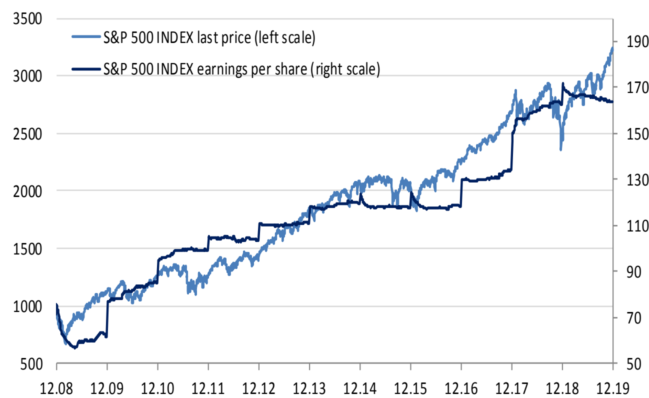
After this peak of monetary creation, the Federal Reserve tried to normalise or sterilise its action by reducing its balance sheet from USD 668 billion back to 579 billion, creating the context that brought about the drop in equities.

What is there to fear in the short term if markets depend on liquidity?

The rise in equity markets has thus been closely linked with movements in interest rates and ultra-accommodative monetary policies. It is estimated that approximately 90% of the increase in prices in 2019 boils down to this factor. If you consider that high equity valuations in a low rate context can still be acceptable, as supported by some models, then the risks are focused on further shifts in interest rates and central bank liquidity.

Nevertheless, it appears clear that the exceptional growth in bond markets, and more specifically in investments peripheral to investment grade debt cannot continue indefinitely.

S&P 500 index and earnings estimates



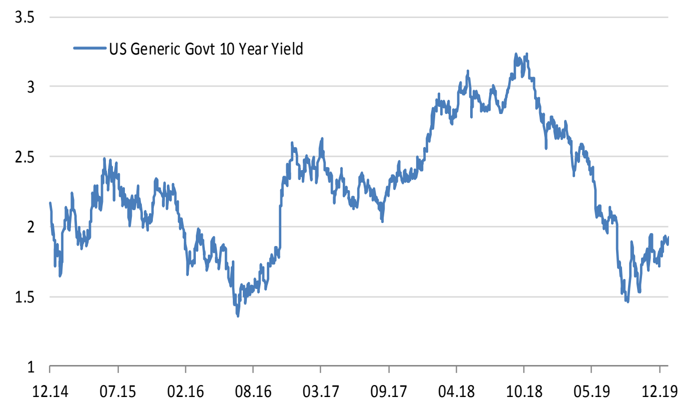
Sources: Bloomberg, BearBull

Monetary injections in Q4 2019 may also, as was the case in 2000 following the massive action in 1999, be followed by a year of stabilisation of the Fed's balance sheet, especially if 2020 holds its promises on an economic level, which is likely to be the case after monetary policies returned to the front of the stage since the summer of 2019.

US GDP growth may well close in on +2.2% this year if no external shock undermines current trends, in which case recession risks would likely be completely averted, and expectations regarding appropriate interest rate levels might then return to normal in 2020.

The yield curve is also likely to normalise thanks to an upward movement on all maturities, aside from the short end.

US Treasury 10-year yields



Sources: Bloomberg, BearBull

Hence, if interest rates gradually climb back up in the US from 1.8% to 2.5% for example on ten-year Treasury bonds, the impact on equity markets would likely come as a clear surprise with potential negative effects. However, if this were to happen less gradually and more quickly, the effects would then be more brutal.

Should the increase in liquidity from central banks be reduced, a significant correction in equity markets, of a magnitude not seen in a long time, may be feared in the short term. Should we already see a sign of this trend in the reduction from USD 4,173 to 4,149 billion of the Fed's balance sheet in the first week of 2020?

Be that as it may, the Federal Reserve may also remain positively biased and continue injecting liquidity in the next few months at a significantly lower pace, although sufficient to enable risky assets to continue rising. It is also possible that the +10% earnings growth expectations for 2020 finally materialise, supporting the markets' extreme levels.

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