Is the Fed Put Kaput?

July 25, 2022

by Mark E. Ricardo

Advisor Perspectives *welcomes guest contributions. The views presented here do not necessarily represent those of* Advisor Perspectives*.*

Given the stock market turmoil, a timely question is whether the U.S. Federal Reserve (the "Fed") will act to stem the tide of losses as it has done during prior stock market declines. A bloated Fed balance sheet and historically high inflation suggest that this time the Fed will be unable to act to save the market.

Fed to the rescue – The Fed put

The Fed put, or the belief on the part of financial market participants that the Fed will take aggressive action to prevent major stock market declines, arose during Alan Greenspan's tenure as chairman. During this period, which ran from 1987 to 2006, the Fed embraced a policy of supporting the economy and the stock market during times of stress by lowering interest rates and adopting other accommodative measures. As a result, the term "Fed put" came about as a play on the term "put option," which is a type of option designed to limit losses.

The concept of the Fed put rose in popularity during the 1987 stock market crash when the Fed quickly acted to lower interest rates and preserve liquidity within the financial system to prevent a protracted decline in stock prices caused by the widespread, and imprudent, use of option and derivative strategies known as portfolio insurance. As a result of the Fed's aggressive actions, the stock market quickly recovered. However, in so acting, the Fed also established the precedent that it would intervene to backstop the economy and the stock market during times of crisis.

This precedent was reinforced by subsequent Fed actions to support the stock market during the savings and loan crisis, the Gulf War, the Asian financial crisis and the collapse of Long-Term Capital Management. However, it was the Fed's actions during the bursting of the dotcom bubble that solidified the existence of the Fed put in the minds of investors. During this period, which ran from March 2000 to October 2002, the stock market suffered a severe downturn caused by a collapse in telecommunications and internet-related stocks. To address this decline, in 2001, the Fed adopted a sustained program of reducing interest rates as a means of supporting the stock market and the economy. This accommodative policy worked so well that the Fed continued it through the end of Greenspan's tenure as Fed chairman.

Following Greenspan's departure as Fed chair, his successors have continued his policy of Fed intervention during times of economic and stock market stress. For example, during the 2008 financial crisis, the Fed, under then Chairman Ben Bernanke, took even more aggressive action to support the economy and the stock market, compared to what it did during the dotcom crisis. To prevent a systemic collapse in the financial system caused by excessive leverage and speculation, in December 2008, the Fed instituted a controversial policy of reducing interest rates to near zero while also engaging in asset purchases to inject massive liquidity into the financial system. This policy, now known as quantitative easing (QE), successfully stabilized the financial system and rejuvenated the stock market.

More recently, in early 2020, the economy seized and the stock market took a nosedive due to the COVID-19 pandemic. Under Chairman Jerome Powell, the Fed again took action to support the economy and the stock market by swiftly slashing interest rates to zero and engaging in the most aggressive campaign of QE to date. This action led to an unprecedented rebound in stock prices with the S&P 500 Index gaining approximately 80% in one year from its March 23, 2020 pandemic low. It also caused the Fed balance sheet to swell from slightly over $4 trillion in February 2020 to almost $9 trillion today.

Today's environment is different

Since 1987, the Fed has been able to support the economy and the stock market during times of crisis by taking aggressive action to cut interest rates and by leveraging its balance sheet to inject liquidity into the financial system. However, these actions were taken when the Fed had a much smaller balance sheet and when inflation was relatively low. It was this economically benign environment that enabled the Fed to take such accommodative measures to rescue the stock market from protracted and painful declines without causing excessive inflation. In fact, during the 2008 financial crisis and, to a lesser degree, during the 2020 COVID crash, a concern of many market participants was that the economy would fall into a deflationary spiral.

Today's environment, however, is very different from these prior crisis periods. Unlike in 1987, 2000, 2008 and 2020, the current stock market decline is accompanied by historically high inflation[1] and a severely bloated Fed balance sheet. To deal with these issues, the Fed is now forced to adopt a policy of quantitative tightening (QT), as opposed to QE. Thus, unlike in prior crisis periods, the Fed is in the unenviable position of having to significantly increase interest rates and reduce its balance sheet in the face of a declining stock market. This will result in a more protracted and deeper stock market decline compared to recent crashes since the Fed will be unable to act to stem the tide of market losses until its balance sheet and inflation are more under control.

What to do now

With this difficult environment at our doorstep, investors should adjust their portfolios to address today's unique challenges.

As a first step, investors should reassess their investment time horizon and risk-tolerance to make sure that they can weather a lengthy and significant market decline. For the reasons previously mentioned, the current market decline is likely to be the most protracted since the bursting of the dotcom bubble in 2000.

Next, they should make sure that the composition of their investment portfolio remains consistent with their investment time horizon and risk-tolerance level. For short-term investors with a low tolerance for risk, this means allocating more of their investment portfolio to cash or short-term fixed income investments. However, for long-term investors, this means making sure that their portfolio remains well diversified among multiple asset classes and strategies, with a particular focus on increasing their exposure to assets that can act as a hedge against inflation, such as commodities, precious metals, real estate and other tangible assets.

Investors also should reduce their exposure to intermediate and long-term bonds. The inverse relationship between bond prices and interest rates means that intermediate and long-term bonds will act as a drag on portfolio performance as long as inflation remains high and interest rates keep rising. Moreover, unlike prior crisis periods that were accompanied by low inflation and declining interest rates, today's high inflation, rising interest rate environment, will cause the correlation between stock and bond returns to become more closely aligned. This in turn will reduce the diversification benefits associated with holding bonds as a hedge against equity risk. However, for low-risk and/or income-oriented investors who want to hold bonds, my suggestion would be to hold short-to-intermediate term U.S. Treasury Inflation-Protected Securities (TIPS) as opposed to longer term, non-inflation linked bonds.

Lastly, investors should add or increase their allocation to strategies that have asymmetric risk-reward characteristics such as those using trend-following, options, volatility and/or long-short investing to hedge against stock market declines. Additional strategies such as those based on special situations, event-driven and private equity opportunities also should be considered since they too have traditionally low correlations with the overall stock market.

Conclusion

Although it's unlikely that the Fed put is forever kaput, historically high inflation and a severely leveraged Fed balance sheet suggests that, unlike in other crisis periods, the Fed will be unable to act to prevent a stock market decline until its balance sheet and inflation are more under control. Until such time, the Fed will be forced to maintain a policy of quantitative tightening, which will make the stock market decline much deeper and more protracted compared to those of recent memory.

To navigate this challenging environment, investors should reassess their investment time horizon and risk-tolerance to make sure that they can weather a significant and protracted market decline. Long-term investors also should make sure that their portfolio remains well diversified among multiple asset classes and strategies, with a particular focus on increasing their exposure to assets that can act as a hedge against inflation. Finally, they should reduce their intermediate and long-term bond allocations and add or increase their exposure to strategies that have asymmetric risk-return characteristics and low historic correlations with stocks.

Mark E. Ricardo, JD, LLM, AAMS®, *is president and chief investment officer of MER Capital Management, a quantitative money management firm specializing in providing risk-managed equity portfolios to individuals,*

institutions, and other investment advisory firms through separately managed accounts and model portfolios. Additional information about Mr. Ricardo and MER Capital Management can be obtained at www.mercapitalmanagement.com. Mr. Ricardo can be contacted at mark@mercapitalmanagement.com.

[1] As of the date of this article consumer price inflation is at a 40-year high. See here.

