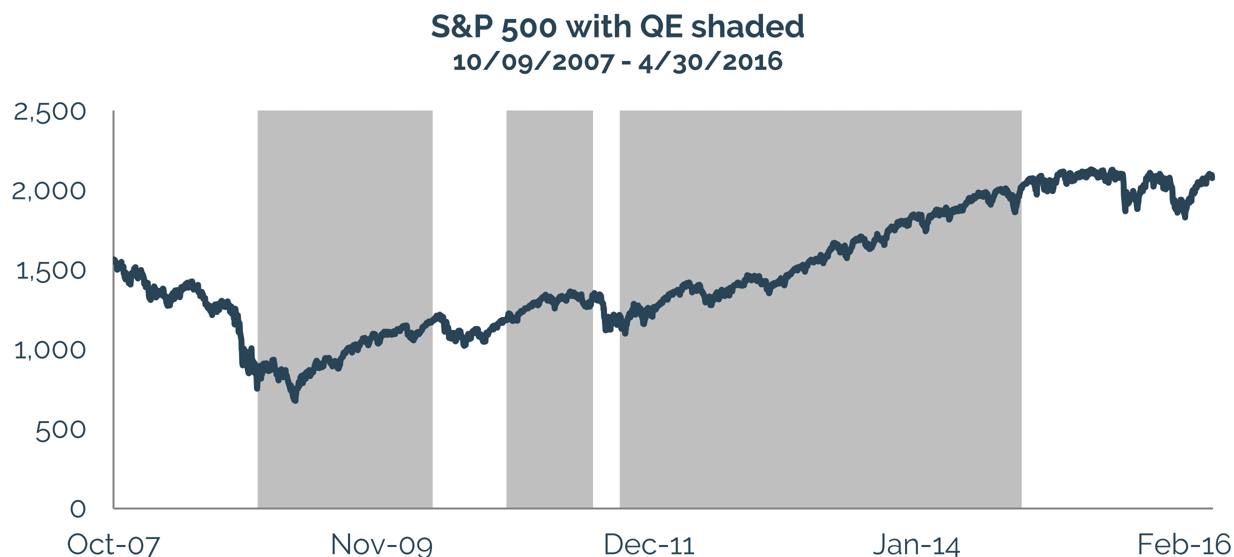
What Time Is It?

Source: Hedgeye

The first step on the road to recovery is to admit you have a problem. And we have a big problem. The world has an addiction to Central Bank monetary policy. We can't seem to get enough of it. Most recently, the Bank of Japan decided to keep their current negative interest rate policy and 80 Trillion Yen a year quantitative easing program unchanged for the time being. The expectation was to cut interest rates deeper into negative territory and possibly increase their QE program. Since negative interest rates and 80 Trillion Yen a year in asset purchases is clearly not enough, the Nikkei immediately dropped close to 5% within a 15 minute time span. We have a problem. And, if we're not careful, the actions by Central Banks around the world may create a dangerous precedent and expectation of support going forward.

In the United States, the Federal Reserve played a huge role in saving us from the depths of an impending depression. Some argue they prevented a much needed cleanse from a buildup of excesses over several years within the financial system. Others contend that the Federal Reserve actually didn't do enough to plant the seeds for a robust recovery. Regardless of which side you choose, there is no denying that after 8+ years of extreme monetary measures, the Federal Reserve has created a dependency on their actions.

Not that long ago, stocks were widely considered to be a claim on a corporation's assets and earnings and were valued accordingly. As I have written extensively over the past year, it seems as if company fundamentals have little to do anymore with overall stock prices. Unfortunately, it seems that the only thing that really matters is Federal Reserve policy. And, everything else that use to matter is just noise. The chart below shows the S&P 500 since the previous market top in October 2007. The shaded areas represent each time the Federal Reserve provided some type of monetary stimulus.

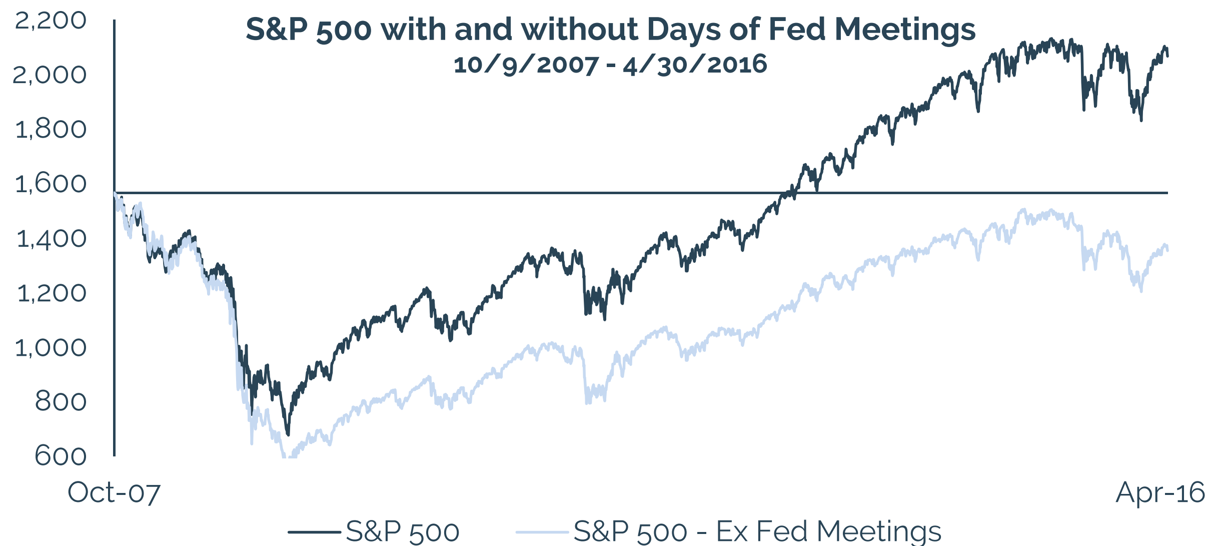


Federal Reserve Action	Timeline	Return During the Period
QE 1	December 2008 - March 2010	+36.4%
Post QE 1	April 2008 - October 2010	+1.3%
QE 2	November 2010 - June 2011	+10.2%
Post QE 2	July 2011 - August 2011	-10.3%
Operation Twist & QE 3	September 2011 - October 2014	+73.0%
Post QE 3	November 2014 - April 2016 (Current)	+2.4%

Do you notice a pattern here? The best time to be in the stock market was when the Federal Reserve was most active in providing stimulus. Otherwise, when the Federal Reserve took a hiatus from Quantitative Easing the stock market either fell or went virtually nowhere.

In the most recent issue of ***The Tandem Report***, John Carew commented on the Federal Reserve's influence on the stock market.

"The Fed's distortion of markets cannot be overstated. To that end, we uncovered some interesting data and share it with you now. Since October 9, 2007, the S&P's price has increased 31.6%. If we remove the days that the FOMC met over that time period, the price change is -13.8%. Wow. Can the Fed really account for more than 100% of the market's gains?"



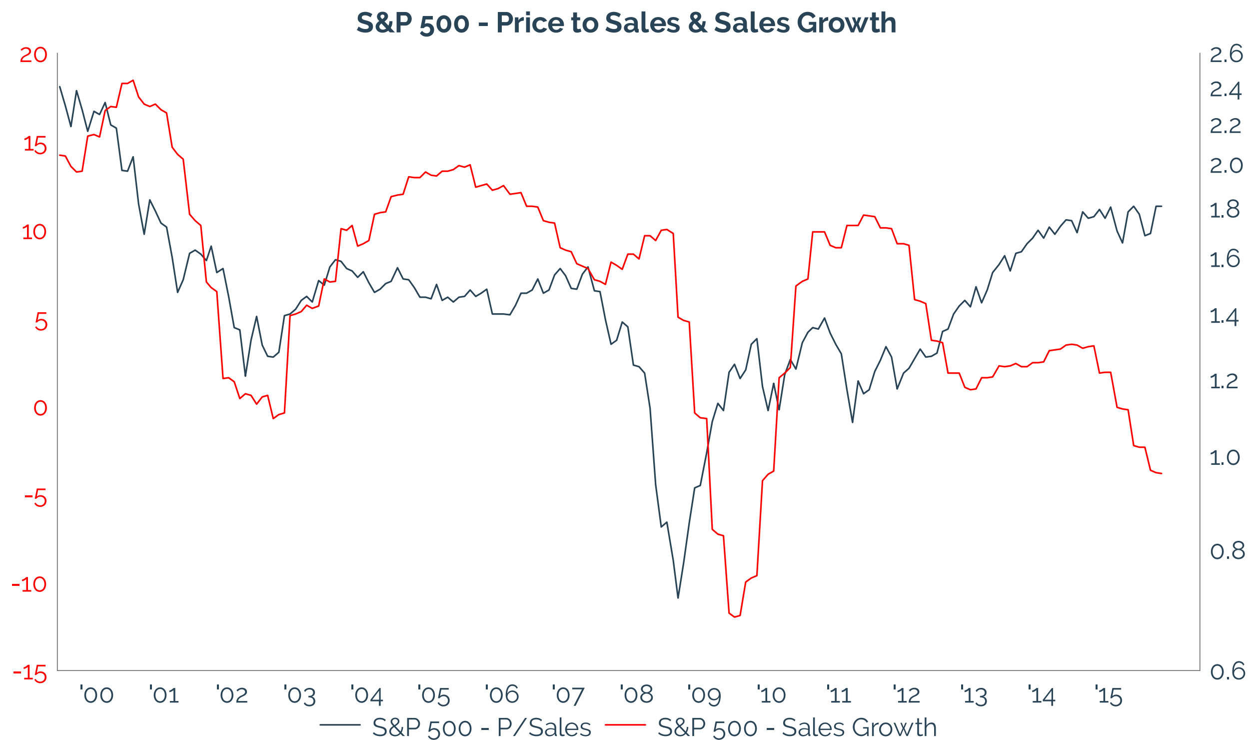
Sources: FactSet for prices and www.federalreserve.gov for Fed FOMC meeting days.

Absolutely the Federal Reserve can account for more than 100% of the market gains! And, they managed to do this while only meeting during 126 of the 2,151 trading days since October 9, 2007. In hindsight, I clearly overworked myself during the past 8+ years considering only 6% of the trading days have really mattered! I say all of this tongue-in-cheek, but the reality is the Federal Reserve is setting a dangerous precedent going forward.

It has been over 8 years since the Great Recession and we still hang on to every last word from Central Banks around the world. Since that time, globally we have gone through over 600 interest rate cuts coupled with nearly $13 Trillion worth of asset purchases through different QE programs. After all of this, we are left with one of the slowest recoveries on record. And, we still beg for the drugs knowing after all this time the extraordinary monetary policies have done very little to stimulate the U.S. economy, or the World economy for that matter. Why? Because with it, we know the stock market will go up and that makes us feel good. But, you should be very careful about what you wish for. I, nor anyone else, knows how this all ends. However, I do suspect that the longer Central Banks overstay their welcome the harsher the consequences of their actions will be.

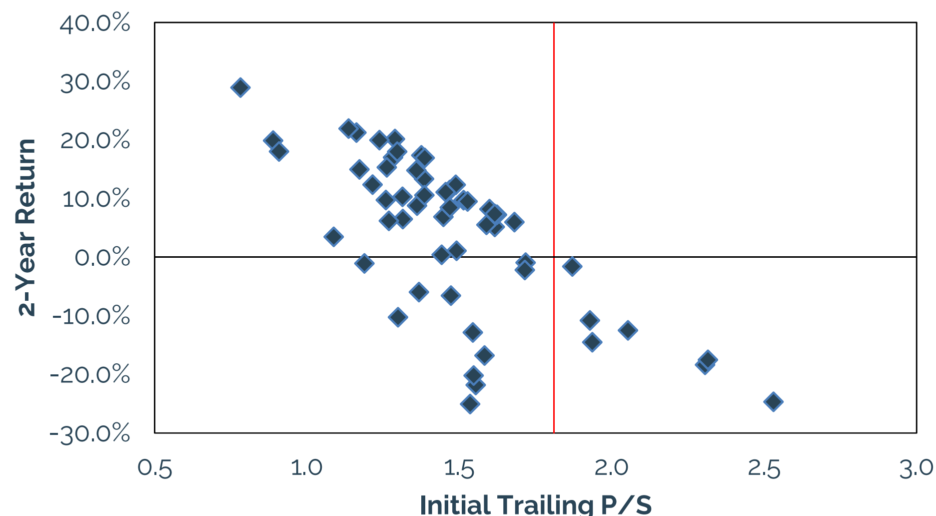
But what if there are no consequences? Could we actually live in a world where fundamentals and historical valuation metrics are no longer useful? I suppose so, but I'm not quite there yet. Maybe our dependency on Central Bank monetary policy is here to stay forever. If that's the case, we would need to adapt and change the way we actually invest. I grant you that in a world of ZIRP (zero interest rate policy) and NIRP (negative interest rate policy), on a relative value basis equity valuations are not crazy expensive. What I just cannot get my arms around is the utter disregard of fundamentals. I look at company financial statements every day, and I'm constantly shocked at the premium investors are willing to pay for the lack of revenue growth.

There is an amazingly large number of companies that have not grown revenues for the past 5+ years and investors still find it necessary to continue to pay up for these stocks. The chart below shows the price to sales ratio for the S&P 500 along with the year over year growth rate of sales. The information goes back to December 1999, which is as far back as Factset goes on the S&P 500.



Source: Factset

You will notice is that over the past 16 years, the sales growth rate was positively correlated with the price to sales ratio until the end of 2012. At this time, the correlation broke and price appreciated at a much greater clip than sales. Is it any coincidence that on December 12th, 2012 the Federal Reserve increased its asset purchases under QE3 from $40 billion to $85 billion per month? Maybe, but probably not. The big question is whether or not sales accelerate from here to validate stock prices and current valuations. The following chart shows the distribution of two year annualized returns based on the initial price to sales ratio over the past 16 years. To provide you with a reference point, the S&P 500 currently has a price to sales ratio of 1.81, which is the red vertical line in the chart.



Source: Factset

LTM P/S	2 Yr Annualized Return
2.0+	-18.3%
1.75 - 2.0	-9.0%
1.50 - 1.75	-2.7%
1.25 - 1.50	8.9%
1.0 - 1.25	13.3%
0.75 - 1.0	22.3%

It's painfully obvious that over the past 16 years as the price to sales ratio increased, the returns of the S&P 500 got worse. In fact, over this time period, there has not been a single two year annualized return that was positive at the current price to sales ratio of 1.81 or higher.

But again I ask, does this historical valuation analysis matter in today's environment? I admit it hasn't over the past few years. If companies could just show some growth, it would be much easier to justify higher valuations in the relative world we live in. However, it's awfully difficult to join the party after 2AM just because everyone else is doing it. The Federal Reserve, whether through its continuous talking down of future rate hikes, and the Bank of Japan, estimated to be a top 10 owner in roughly 90% of the Nikkei 225, continue to fuel our dependency on easy monetary policy. Parties are always fun in the moment and this one could very well go on for a lot longer than any of us could possibly fathom. Eventually we will come down from the high and value companies as we've done in the past. Until then, strap on your dancing shoes and enjoy the ride, but remember the old saying - "nothing good happens after 2AM".

--Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson

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