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Yesterday Was A Very Important Day

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There aren't many days in our lives that are meaningful. There are the obvious of course – graduation, first job, marriage, birth of a child and so on. It's human nature to reflect upon life's important days as happy moments. Important days in the market however, tend to dwell on the not-so-happy – 1929 market crash, black Monday, dot-com bubble, global financial crisis and the like.

While it's too early to say for sure, I suspect the market may remember yesterday as one of the not-so-happy moments. The day started out innocuously enough. The normal pre-market announcements and data started rolling in around 8AM. As is usually the case, there is one announcement which is more important than the other. Yesterday it was the ADP Nonfarm Employment Report. You may recognize ADP, formerly known as Automatic Data Processing, as the company which distributes many payroll checks for employers. At some point, they realized they had a goldmine of data and began publishing the payroll ups and downs as an indicator of economic health. It, along with the government run Bureau of Labor Statistics, are the two most followed employment related indicators available.

Anyway, the ADP indicator was released yesterday morning at 8:15 AM (they tend to release important information when the market is closed so as not to freak everyone out). Yesterday, ADP announced an increase in nonfarm private sector employment of 263 thousand people. That's great news as it shows an increasing workforce! What makes it even better is that analysts were expecting an increase of 187 thousand – meaning, roughly 80 thousand more people landed jobs than expected. Awesome for them and awesome for a growing economy. While there hasn't been much, or anything, in terms of specific government policy which would suggest such a move, I think it's fair to say Trump has successfully used the power of the bully pulpit to push his pro-growth agenda.

So far, so good. Good economic news is often reflected in good market performance, particularly when it's better than expected. Using the chart below we can see the immediate impact. Pre-market (yes, the markets effectively trade 24 hours a day) the S&P gapped (jumped without any trades between) 6.43 points (about 0.27%). Not a huge number but an indication of happiness by investors. The mood continued to be buoyed as the market ran to its intra-day high of 2378.36 (up 0.77%). Again, not huge numbers but a start to a very good day.

Then reality hit. At 2PM (the Fed doesn't pay attention to the don't-freak-everyone-out rule), the Federal Reserve released minutes of their most recent meeting, which happened March 15th. During this meeting, the Fed discusses many things – the state of the economy, data items of interest, inflation, interest rates as well as make policy decisions. While their policy decisions get the most publicity, the tenor, tone and subject of their discussions are dissected in an effort to understand any future action they may take. In this meeting, there were three items of particular interest:

1. <u>Inflation and impact on interest rate policy</u> – effectively, participants of the meeting saw relatively low inflation (below their 2% target) for "some time". Despite this, the committee felt it was "…important to remove accommodation gradually to help ensure that inflation would stabilize…". The takeaway

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from this discussion is that the Federal Reserve will be raising interest rates. When and how much remain for future meetings, but the decision is quite obvious.

2. The Fed's balance sheet – I could write a whole thesis on this subject, but in short - in the Fed's past efforts to stimulate the economy after the Global Financial Crisis, the Fed bought securities (bonds) in order to lower interest rates and supply liquidity (they pay for the bonds with cash) to help get the economy moving. After years of doing this, and with an unlimited supply of funds (thanks to the blank check afforded by the US Treasury) the Fed's balance sheet is huge! At some point, the Fed will have to sell these securities, or let them mature. How to do so without disrupting the economy and the market is a significant problem. During the meeting this issue came up, "participants agreed that reductions in the Federal Reserve's securities holdings should be gradual and predictable, and accomplished primarily by phasing out reinvestments of principal received from those holdings." In this case, the Fed is telling the world that they will no longer be buying securities, but that they will not be aggressively trying to sell them either. They will let them mature and take no action with the proceeds. In other words, the flow of money will no longer be going from the Fed to the world, it will now reverse course, albeit gradually. Effectively, the Fed decided in March to end quantitative easing.
3. The stock market – While the Fed has no direct impact on the market, it considers the indirect impact of their actions and the subsequent impact on the economy when making decisions. In this case, "A few participants attributed the recent equity price appreciation to expectations for corporate tax cuts or to increased risk tolerance among investors rather than to expectations of stronger economic growth. Some participants viewed equity prices as quite high relative to standard valuation measures." In other words, the Fed is worried about the high price of the stock market and what the economic impact of a market fall would mean.

Looking at the chart below, we can see the immediate impact the release of the Fed's minutes had on the market – gap down, and continue down to end lower for the day.

It has been my thesis for quite some time, that investors have over-anticipated the impact of Trump's policies. I believe they have expected all of his policies to be implemented, that they would be implemented exactly as he has described and that they would be implemented quickly. Actually, I believe Trump believes this too. However, for better or worse, Washington doesn't work that way. There are too many cooks in the kitchen and politics these days seems to be more about making a good show and making others look bad than getting anything meaningful accomplished. It is for these reasons that I have been skeptical of the market's run-up in anticipation of Trump's tax breaks and regulatory roll-back. The market, I believe, has gotten ahead of itself and as a result is now overvalued relative to our real economic state. Basically, we're in good shape, but not as good as the market thinks.

Returning to the original subject, why do these two events make yesterday an important day. The reason is quite simple actually. I believe the action of yesterday's market is an indication that investors are finally coming back to reality. On the one hand, the jobs report is a reflection of Trump's talk and not of policy. The market likes the positive result and jumps up to reflect the development. On the other, the reality is that the market and economy will no longer be supported by an accommodative Federal Reserve through lower interest rates and/or security purchases meant to foster liquidity. Investors immediately recognize the true impact of this move on the fundamental state of the economy, and the market.

Breaking it down even further, we have an early market move based on sentiment versus a late market move based on fundamentals. As we have seen many times in history, sentiment can win for a while, but in the end, fundamentals matter. In this case, the fundamentals are telling us that the Fed-led party is over. It happened yesterday, April 5th, at 2PM.