The Fed Doesn't Just Print Money, It Also Prints Alpha

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"It sometimes feels that the Federal Reserve is more concerned about which way the next 50 points in the S&P go than your average hedge fund manager is." – *David Einhorn (an above-average hedge fund manager)*

The Federal Reserve is a factory of sorts. It manufactures money, of course. It also manufactures, as a by-product, very high-quality "alpha" – which is finance-speak for an investment opportunity that offers returns well above the market average, the chance to "beat the market."

Finding alpha is normally quite challenging – very few investors can do it well – but Fed-sourced alpha is easy to find, easy to understand, easy to harvest, and has been reliably available for quite some time.

Federal Reserve Board Chairman Jerome Powell listens during a hearing of the Senate Banking, Housing and Urban Affairs Committee on Capitol Hill February 12, 2020, in Washington, DC. - Market sentiment has been positive since US Federal Reserve Chairman Jerome Powell said on Tuesday that its assessment of the economic fallout was not as gloomy as many had expected. (Photo by Brendan Smialowski / AFP) (Photo by BRENDAN SMIALOWSKI/AFP via Getty Images) AFP VIA GETTY IMAGES

Evidence

Consider:

- "In the past few decades stocks in the U.S. and several other major economies have experienced large excess returns in anticipation of U.S. monetary policy decisions made at scheduled policy meetings. We refer to this phenomenon as the pre-FOMC announcement drift…"
- "Since 1994 about 80% of realized excess stock returns in the U.S. have been earned in the 24 hours before scheduled monetary policy announcements. …. The S&P500 index has on average increased 49 basis points in the 24 hours before scheduled FOMC [Federal Open Market Committee] announcements. These returns do not revert in subsequent trading days and are orders of magnitude larger than those outside the 24-hour pre-FOMC window. The statistical significance of the pre-FOMC return is very high."

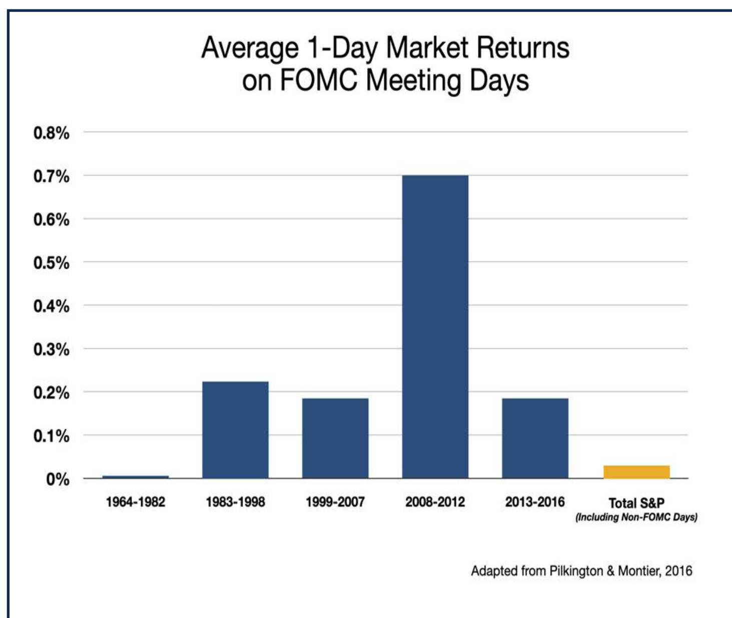
Underscore that conclusion. "Excess returns" refers to the outperformance of the selected sample (in this case a time-window) relative to the market benchmark – which *is* the definition of alpha. So, if I read this correctly, **80% of the alpha generated by the market over three decades (ending 2011) was produced/inspired/conjured up by the Fed.**

The authors of this rather famous study (two Federal Reserve economists!) used "high frequency" (tick-level) price data to craft a day-trading strategy ("buying the SPX at 2 pm the day before a scheduled FOMC announcement, and selling 15 minutes before the announcement"). This alpha was unusually potent.

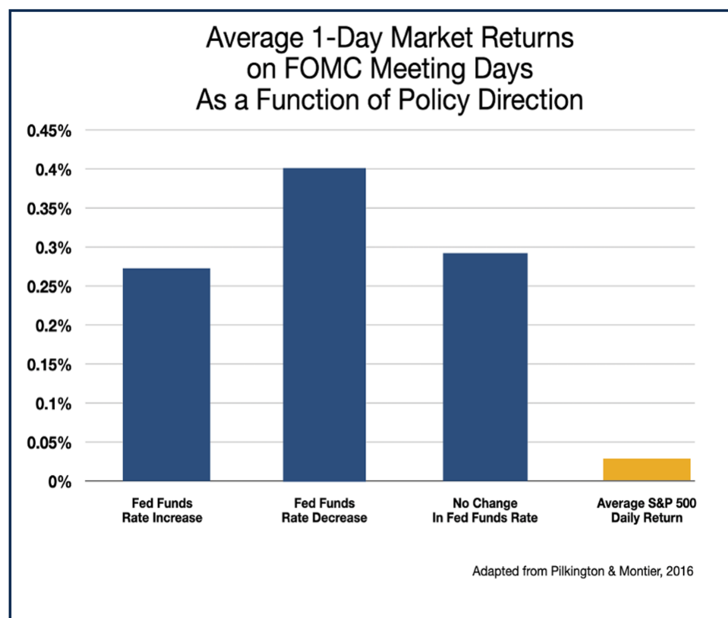
- "The excess return on the SPX over the 24 hours prior to the FOMC announcement has on average been 3.89% per year, it has only been 0.88% on all remaining trading days."

If this approach is a little too tricky for many investors, James Montier and Philip Pilkington of the investment firm GMO offer a simpler formula. They used *daily* closing prices and returns for 1964-2016. To measure the effect of the Fed's policy moves they simply deleted the handful of days on which FOMC meetings occurred.

- "All we did here was to remove the days on which the FOMC met; nothing more, nothing less. This means that we removed around 18 days a year in the 1960s, 14 days a year in the 1970s, and 8 days a year from 1981 onwards. During the period 1964 to 1983 there was absolutely no effect from removing these days. But, from 1985 onwards, removing fewer days began to have a major and increasing impact on the market. In fact, FOMC days account for 25% of the total real returns we have witnessed since 1984!"



Avg FOMC-Day Returns by Time period CHART BY AUTHOR



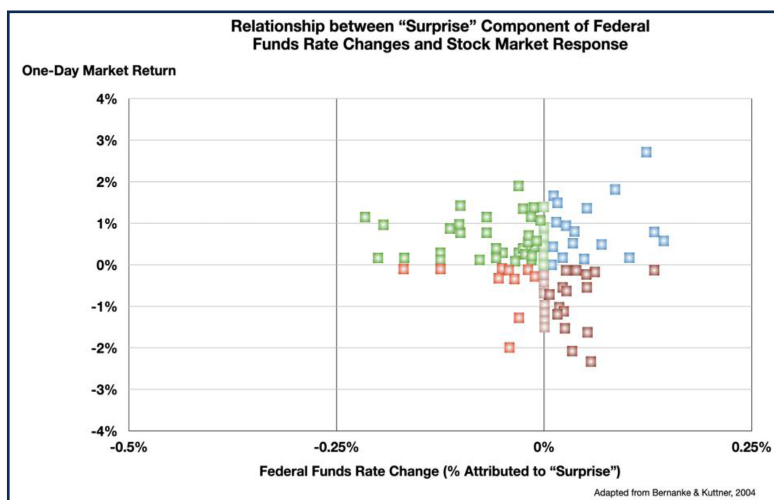
Avg FOMC-Day Return by Direction of Policy Move CHART BY AUTHOR

The strongest effect occurred in the QE era, 2008-2012, the period of most active monetary stimulus. It does not matter whether the Fed raises or lowers interest rates. The mere suggestion of monetary proactivity is enough to juice returns.

Then there's this, from Ruchir Sharma, the chief global strategist at Morgan Stanley, writing in September 2016:

- "Since the Fed began aggressive monetary easing in 2008, my calculations show that nearly 60% of stock market gains have come on those days, once every six weeks, that the Federal Open Market Committee announces its policy decisions. Put another way, the S&P 500 index has gained 699 points since January 2008, and 422 of those points came on the 70 Fed announcement days. The average gain on announcement days was roughly 50 times higher than the average gain on other days."

Future Fed Chairman Ben **Bernanke** himself co-authored a study in 2004 that attempted to pick apart the market's response to Fed moves into "anticipated" vs "surprise" components. He concluded that the market gains on average 1% on the day of a "hypothetical 25 basis point easing" (i.e. a stimulus). This is a *huge* 1-day bump. The scattergram of over 100 events shows the alpha is concentrated strongly in the stimulative direction – rate *decreases* – in the left half of the figure below. (The market's response to rate increases is more balanced.)



Bernanke & Kuttner Study of Surprise Effect of Fed Rate Changes CHART BY AUTHOR

Where Does the Fed-Alpha Come From?

This particular type of alpha is driven by the emergence of what we may call "Stimulus Economics," which is perhaps a novel term; so to explain, briefly –

In the classical view, the economy is a self-driving car, capable of adjusting to "shocks" and finding its way out of trouble without needing the government to help "steer" – except in true emergencies. According to "stimulus eco-

nomics," while the government may not actually steer the economy – the U.S. still eschews "industrial policy," picking winners and losers (although that slope is slippery of late) – the appropriate organs of the state (such as the Fed, or Treasury) sit at their control panels, with various gauges to monitor and buttons to push, to add or withhold different kinds of "stimulus," adjusting the dosages up and down, but never withdrawing it fully. "Stimulus" has become a permanent feature of economic policy. There is even discussion of making it "automatic" – so that the "stimulus" mechanism would start to resemble a thermostat, turning on and off in response to specific economic triggers.

Stimulus economics is non-ideological, improvisational, acutely pragmatic, and acutely focused on the health of the financial system in particular. Above all, it implies an activist mindset. It is not well-grounded in "theory" yet, so perhaps it should be referred to for now as "stimulus engineering." And it is also still quite puzzling in many ways, even to its chief practitioners (e.g., Fed leaders). Some of the gauges seem to stick (e.g., the "inflation" thermometer), and some of the buttons don't always work.

The roots of this thinking date back a hundred years (that will be another column). But the idea that "stimulus" is not just an emergency measure, that it can be seen as a standard part of the policy tool-kit, and can be employed on a regular basis to fine-tune the economy or spark up the financial markets – this view began to emerge in the 1980s (see below). It was prompted in part by the October 1987 Black Monday stock market crash, which struck like a bolt out of the blue and cut the market's value by 22% in one day. Alan Greenspan – who had taken office as Fed Chairman just two months earlier – immediately lowered interest rates, and made an "extraordinary" announcement:

- "The Federal Reserve affirms today its readiness to serve as a source of liquidity to support the economic and financial system."

"Liquidity" meant "stimulus" – he was saying he would flood the system with money, if necessary. It was the world's first "Whatever-It-Takes" moment.

Greenspan was the Fed chairman for 19 years and 4 Presidents. He became a legend in his own time, a great Sphinx possessed of deep, inscrutable knowledge and capable of moving markets with an apt half-sentence. He subtilized the Federal Reserve. Paul Volcker (Greenspan's predecessor) smoked big cigars and bludgeoned the economy to kill inflation. Greenspan – the "maestro" – played it like a violin. The official history of the Federal Reserve written 25 years later said that "the Fed's response to Black Monday ushered in a new era of investor confidence in the central bank's ability to calm severe market downturns." Formally, Greenspan was the head of the nation's central bank, but his presence loomed over the financial markets. Investors started to talk about the Greenspan Put. (Implying that in case of a serious market downturn, the Federal reserve would jack up the stimulus, lower interest rates, rain down buckets of liquidity… to stimulate the market, bail investors out, in effect insuring investors against serious losses – the same function served by a Put Option.) Eventually this became the Bernanke Put ("Can the Markets Live Without It?" *New Yorker Magazine* asked in 2013); then the Yellen Put; now the Powell Put.

It is ironic that Alan Greenspan, a champion of a libertarian-tinged laissez-faire economics, an acolyte of Ayn Rand, was responsible for initiating an ongoing and ultimately very nuanced activism, managing of the Fed's stimulus options with a deft touch, and by his skill he helped convince much of the policy establishment of the merits of a more proactive approach to economic policy. In fact, he could be said to have legitimized modern Stimulus Economics/Engineering.

Each new crisis (Long-Term Capital Management, the dot-com crash, 9/11) has reinforced the case for activism. Following the 2008 financial crash, "stimulus" has become the dominant mindset. The debates are about how, and how much to stimulate, not if, or whether. And of course today, with Covid-19, the spigots are wide open. The Stimulus Economy holds sway over both Wall Street and Main Street.

With bizarre results. Consider what has happened in the last 100 days. The stock market is enjoying the "best of times" (Q2 2020 was the best quarter since 1998) while the real economy faces the "worst of times." It is "the great disconnect," an affront to common sense, but – there it is. Maybe the market is omniscient, and can foresee that V-shaped recovery which now seems so improbable. Maybe the capitalists are all in an apres-nous-le-déluge delirium.

Or – might it not be that several *trillion* dollars in fiscal and monetary stimulus in the last 100 days have swept aside all the conventional calculations to drive prices up on pure adrenalin? Investors are no longer focused principally on the valuations of private enterprise, on optimizing capital allocation, or even the excitement over technological miracles to come (Tesla?). In fact, the financial markets seem less concerned with "recovery" of the real economy (which is expected in due course, whenever that may be) than with the effect of the stimulus on asset values, on the stock market. They are fixated on the twitches and tremors in Chairman Powell's public performances.

"Stimulus Economics" – Empowerment and Risk

Bernanke saw all this as godsend to stimulus engineers.

- "The ultimate objectives of monetary policy are expressed in terms of macroeconomic variables such as output, employment and inflation…but the influence of monetary policy on these variables is at best indirect. The most direct and immediate effects of monetary policy actions are on the financial markets."

He carried the lesson with him when he became the Fed Chairman. It empowered a more proactive stimulus program in response to the 2008 crisis. Lowering interest rates and other forms of monetary stimulus (especially quantitative easing, "QE") drove up stock prices; people felt wealthier, and loosened their pocketbooks; consumer spending rose; and so the stimulus effect was transmitted to the real economy. Monetary policy was no longer the weaker option. The Fed's grip on the financial world solidified. The market tripled in value, despite a weak and prolonged recovery in the real economy. Stimulus "worked." What could be better than that?

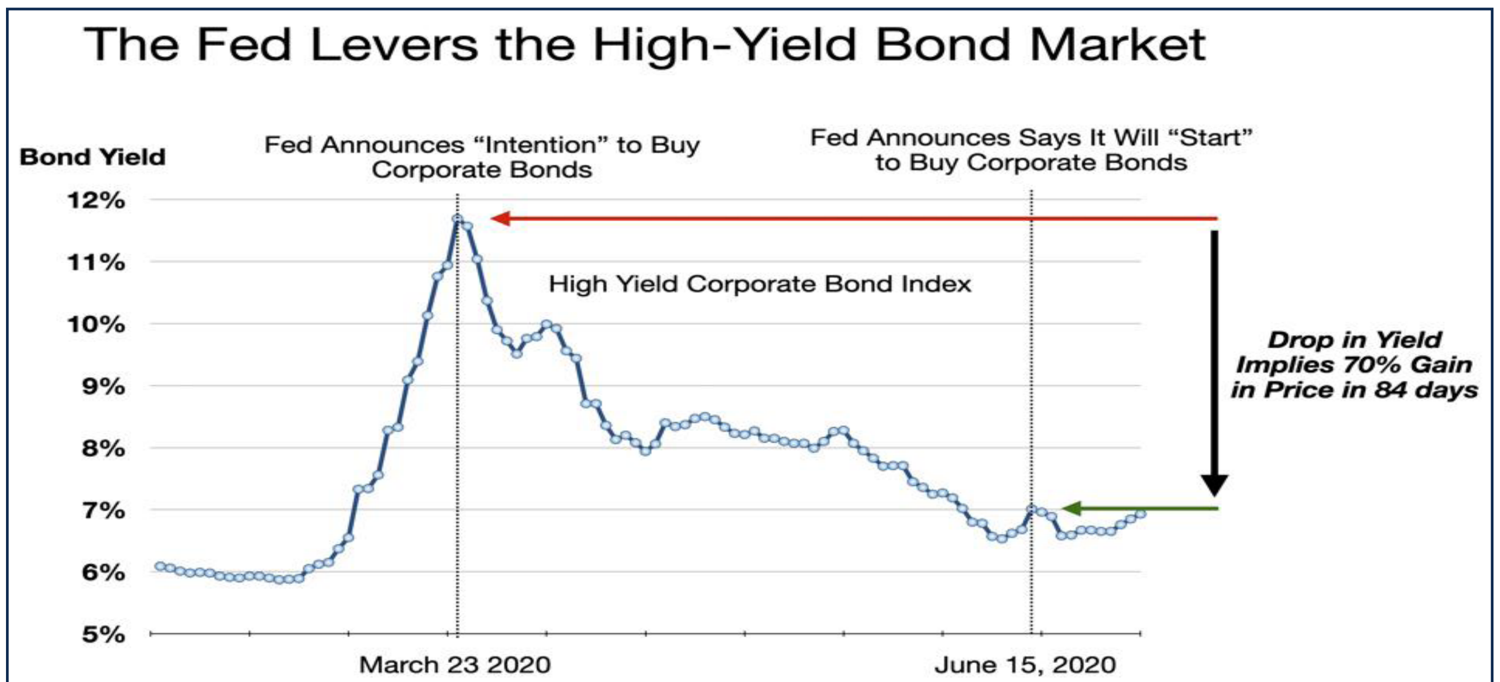
But many people are worried by the urgency with which the market now clings to Fed policy as its valuation anchor. The Fed itself has taken note, and would rather tamp down the market's over-sensitivity. In 2011, it initiated a new communications calendar with press conferences pre-scheduled for only every other FOMC meeting. The alpha migrated to the meetings accompanied by the press conferences, and dried up for the others. In 2018, the Fed went to having press conferences after *every* FOMC meeting, in an attempt to modulate its influence over the markets. A late study (through 2019) suggested that some of the Fed-alpha may have been disappearing recently.

The Covid crisis and the return of Stimulus Economics have brought it back. Historically, stronger stimulus has driven stronger alpha.

- "The effect of Fed announcements rose sharply after 2008 when the Fed launched the early rounds of quantitative easing."

The Fed's current round of intense activism has indeed unleashed a rich new flood of alpha. The latest extraordinary illustration is the turnaround in the bond market, particular the high yield segment, produced by the Fed's announcement in March that it might, for the first time ever, buy *corporate* bonds as part of QE. It turned a rout into a rally overnight. Since March, the high-yield market has been hemorrhaging alpha – even before the Fed had bought any bonds. (They did nibble at the Bond ETF market – buying a little over $1 billion, just enough to signal their intentions.)

Fed-alpha is real. But is it a sign of systemic health and fitness? Are we becoming addicted to "stimulus"? Is the market being distorted by it? The cycles of Surge and Sag now come in waves, and at each moment of hesitation the markets begin chorus-



Fed Move Impact on the Hi Yield Bond Market CHART BY AUTHOR

ing for more – more stimulus, please, another trillion. How did the economy, and the financial markets, so lose touch with "the fundamentals"? How did the Real Economy comprised of actual businesses making and selling actual products and services to actual human beings, making actual profits – which stock market values are supposed to be based on – become a more shallow-minded Stimulus Economy, waiting with its begging bowl for each new dollop of QE or tax credits or government spending and parsing the minutes of the Federal Reserve more closely than corporate earnings statements?

Ruchir Sharma put it succinctly:

- "This is a sign of dysfunction. The stock market should be a barometer of the economy, but in practice it has become a barometer of Fed policy."

There is a half-suppressed awareness that the Covid Bull Market of the last 100 days may be just a stimulus "high," unreal and fleeting – and that when the drug wears off, the detox may be horrific. But there seems no turning back. All that investors want to hear about now is the scope and potency of the next stimulus package.

The godfather of Stimulus Economics – John Maynard Keynes – was pretty smart about this. In 1933, visiting America, he took note of the surge in animal spirits when Roosevelt took office. Roosevelt's activist tone was a psychological stimulus, even if it lacked the substantive punch of real deficit spending. (Keynes hadn't had the chance to make that case yet.) Franklin's very cheerfulness brought hope. The economy roused. Industrial production *almost doubled* between March and June of 1933. But Keynes cautioned:

- "One fears [Roosevelt] is depending far too much on psychological and distinct from real factors… There is a risk of a hiatus when the psychological stimulus will have exhausted itself before the real factors, which are slow moving, will have come into effective operation." – *Cited in Robert Skidelsky's biography of Keynes*

John Maynard Keynes, English economist and pioneer of the theory of full employment. GETTY IMAGES

Keynes was right. Franklin's good cheer wore thin. The stimulus faded. "The collapse of the boomlet in the autumn ended Roosevelt's honeymoon period."

2020 is not 1933. One of the fallacies of much of today's finance theory is idea that the financial market is a "natural" system, with invariant "laws" of behavior. This is certainly untrue. "This time" is *always* different, because people learn and technology changes. The aftermath of this latest stimulus injection is not easy to predict. And like all alpha sources, the Fed's alpha ebbs and flows with market weather. But it is now entering a cycle where returns should be strong, for better *and* worse.

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