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Subject: J.P. Morgan Macro Skinny: when the S&P becomes a policy tool

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Macro Skinny

J.P.Morgan

September 16, 2012

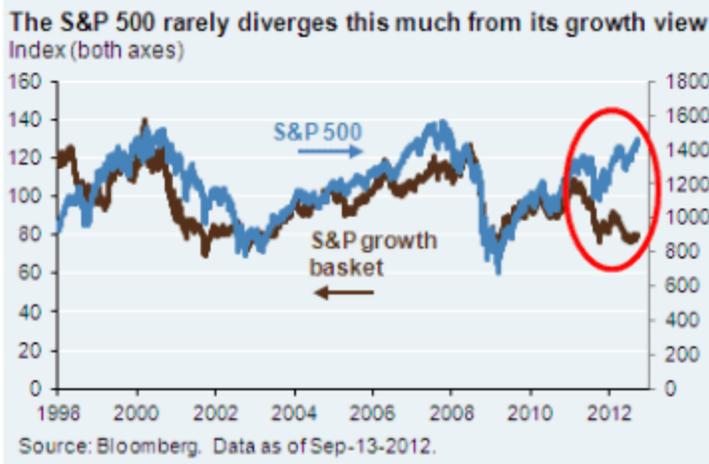
When the S&P becomes a policy tool

1/ In the summer we argued that the Fed's purchases of high duration assets have been forcing a massive divergence between the economy and the stock market (see "Macro Skinny: Fed policy – carry today, growth tomorrow", available upon request). The decision to embark on 'open ended' QE3¹ will likely make this divergence even greater in the coming years. At the risk of making our role as economists obsolete, we would argue that **US data are now much less relevant for the stock market because the stock market itself is now used as a policy tool². By implication, stock prices will likely normalize faster than growth.**

2/ The Bernanke Fed is betting on the existence of wealth effects: as stock and house prices rise, consumers feel wealthier and are more willing to spend³. But historically the wealth effect in the stock market has been weak. And since the housing bust, the transmission of monetary policy through the housing market has been severely constricted as well. With 31% of homeowners still in 'negative equity', wealth extraction from housing will likely remain limited, at least over the next few years. **Bottom line, the Fed is banking on wealth effects from stock and house prices, but it may need to create a lot more wealth for a unit of growth than what past research suggests.**

3/ There is a tendency to assume that markets are efficient and that QE3 is now almost fully priced into equities. The market has certainly rallied impressively into the FOMC announcement and right after it too. But based on prior rounds of Fed moves (QE2, Twist1, Twist2), it appears that once the knee-jerk response of stock prices to the news was over, the portfolio rebalancing effect kicked in. In this second stage, as the Fed buys securities, it commands duration shortfalls and massively lower yields. This forces investors to look for higher-yielding, higher-duration assets elsewhere, including in stock and corporate bond markets⁴. This suggests to us that **QE3 is far from being fully priced in; portfolio rebalancing will likely continue in tandem with more Fed purchases.**

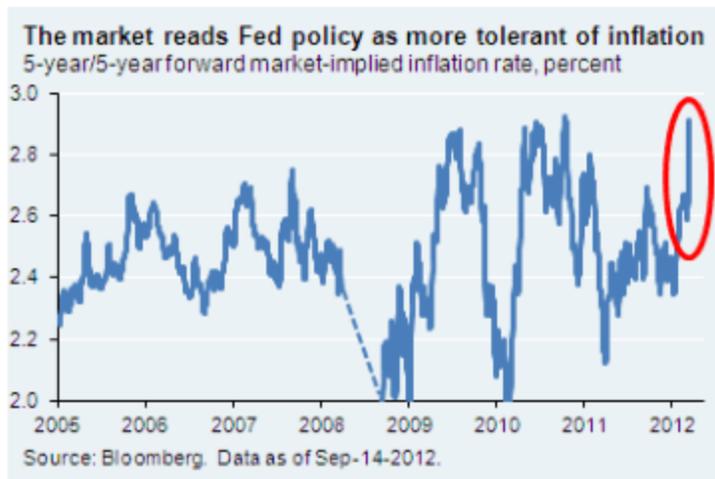
4/ Several market commentators have been arguing that the equity market has delinked from economic growth, and as such, we are due for a market correction. We have two issues with this claim: (a) stocks are being used as a policy tool and (b) stocks are rising but are still bearish on growth. The left chart below demonstrates why the last statement is true: **the 'growthy' part of the S&P⁵ has been as weak as economic activity this past year, yet at the same time the stock market 'chose' to decouple.** The right chart shows that the S&P has rarely diverged this much from its own growth view historically.



5/ One way to see how portfolio rebalancing has promoted stocks is to look at stock performance outside the QE announcement windows (from when the market begins to expect the policy until after the announcement date). The chart below shows how the S&P 500 has fared relative to its own growth view as well as relative to the European market. What's striking, is that even outside of the policy announcement window, US equity prices have repeatedly outperformed market-implied economic growth. **We think this portfolio rebalancing channel will likely remain active as the Fed begins the implementation phase of QE3.**



6/ For now, the output gap is still very wide, and it will take years of above-trend growth for inflation risks to surface in a meaningful way. But long-term inflation expectations, as implied by the TIPS market, already moved up last week (see chart below) and may well extend further in the coming days. The bigger focus from the Fed's perspective, however, is how consumers and businesses adjust their expectations, not financial markets. This makes the next installment of the University of Michigan inflation survey more important, but no need to get too excited: **long term expectations by consumers and businesses won't move significantly higher so easily.**



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[1] The Fed will buy even more duration, but this time they will only stop when the data tells them to.

[2] Stocks should do better under two relatively extreme growth scenarios: (a) Data strengthens substantially from here - Fed will slowdown its duration purchases, which means less support to the stock market, but this will be offset by a meaningful cyclical tailwind. (b) Activity stays relatively weak - no cyclical tailwind for stocks, but this will be compensated by the Fed, which will force a lot more portfolio rebalancing. Our preferred macro scenario is somewhere in between - more monetary tailwind for markets, along with moderately better cyclical support.

[3] In his press conference yesterday, Chairman Bernanke commented that, "We do think that these [QE] policies...also affects stock prices. It affects other asset prices—home prices for example." He then commented that "There are a number of different channels [for QE]...If house prices are rising, people may be more willing to buy homes...So house prices is one vehicle....Stock prices—many people own stocks directly or indirectly."

[4] Chairman Bernanke's [speech](#) at the Jackson Hole Symposium has a detailed discussion on this channel.

[5] A simplified version of this 'growth basket' is long cyclical vs. short defensives. Here though, the sector weights are chosen to best mimic economic growth historically.

Acronyms:

- Fed - Federal Reserve
- FOMC - Federal Open Market Committee
- QE - Quantitative Easing
- S&P - Standard & Poor's

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