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Thoughts On “The Relentless Bid”

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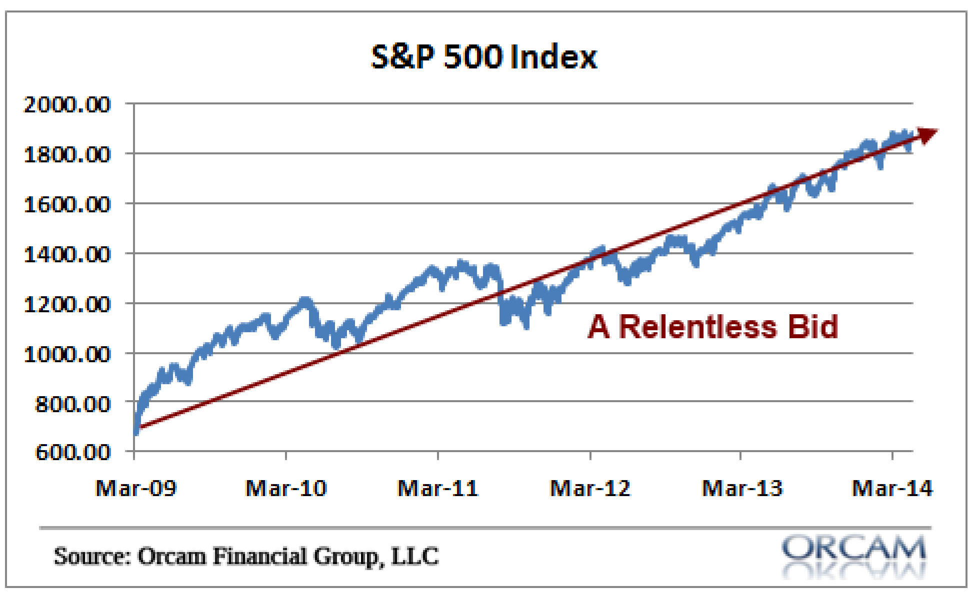
You’ve almost certainly heard about the “relentless bid” in the stock market over the last 5 years. It seems as though every time there is even a minor hiccup in the equity market there is a rush of buyers there to bid up stocks back to new highs. It’s an incredible phenomenon and one that has many investors wondering if there isn’t something extremely unhealthy going on. After all, as you all well know, stability has a tendency to create instability and this seemingly incredible stability sometimes appears to be built on quicksand. Let’s explore that thinking some more.

Maybe there’s more to this buy the dip mentality than we think?

When we hear about this relentless bid under the market the first culprit is always the Federal Reserve and QE. But that story has come under some pressure in recent months as the tapering has begun. Clearly, if tapering were tightening, as many believe, then equities wouldn’t be responding with this relentless eagerness to bid prices higher. But it’s also clear that QE, even with tapering, has contributed to market psychology in a big way.

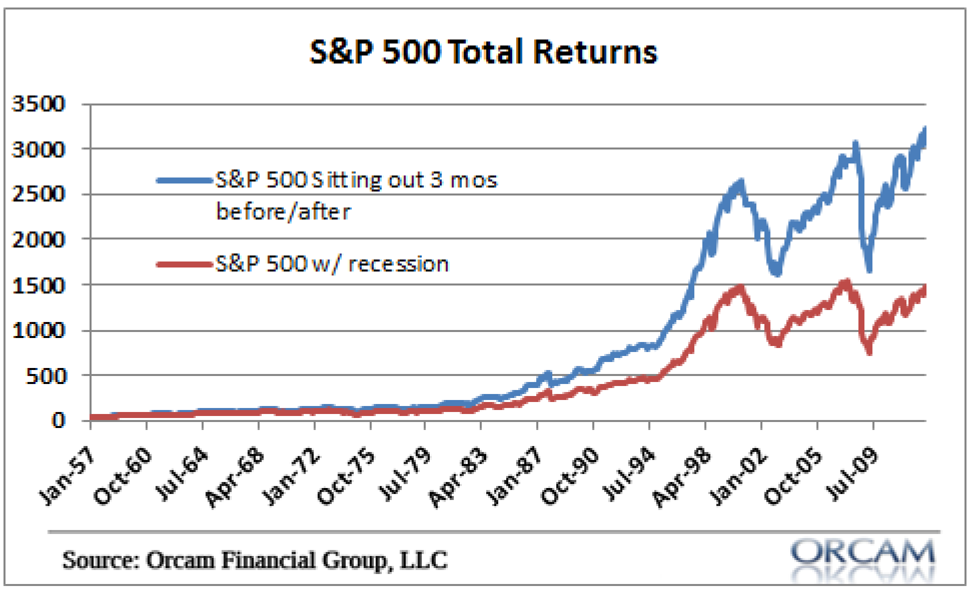


It's also clear that QE, even with tapering, is still creating a portfolio rebalancing effect. That is, every month the stock of privately held MBS and T-bonds is reduced and anyone looking for income or alternative assets must go in search of risk assets (which *could* drive up prices). There's simply no denying that this must have SOME impact on markets.

But there's something bigger occurring here and it's bigger than QE and the Fed. And that's the real economy. This brings an interesting question into the mix—could QE and its various indirect impacts sustain the market rally in the face of a deteriorating or contracting economy? I am not so certain that that's the case and while the economy is certainly not robust, I see no reason to believe that there is significant economic downside risk at this point. Therefore, there's merit to the view that this "relentless bid" isn't entirely irrational.

As I view it, the Fed is merely another economic participant trying to gauge the future path of the economy and enacting policy accordingly. Granted, they're an extremely important entity, but we should not confuse important with omnipotent. After all, while the Fed certainly plays an influential role in the economy, it does not control the entire economy. If economic growth and prosperity were as easy as QE1, 2, 3 then we would have eliminated the business cycle long ago. And I think that the importance of the real economy is often overlooked in favor of this story about the Fed. In fact, at times it is egregiously misportrayed in favor of what is a much sexier story about QE and its mystical powers.

As I've noted often in the past, the market tends to perform at its worst when tail risk is high. And tail risk is highest when recession looms. This isn't all that surprising since the profit cycle tends to correlate with the economic cycle. And the market cycle is simply the price action trying to anticipate when these potential risks appear. It's interesting to note the extreme outperformance of the S&P 500 without recessions. If we were able to perfectly time recessions and sit out of the S&P 500 during the three month period both before and after a recession we'd generate a return that was over TWICE the total return of the S&P 500 since 1957.



So perhaps the relentless bid isn't as irrational as it looks. If the odds of recession remain low then the odds of a tail risk event are low. Therefore, the equity markets simply aren't becoming spooked by anything they see in the current environment. When you throw in the psychological impact of continuing QE you get a recipe for a "buy the dip" mentality. And while it might look irrational I think that a look under the surface tells us that maybe this isn't so irrational after all. Of course, this doesn't mean the market has become impervious to substantial declines, but if we are approaching the markets from the perspective of a probabilistic approach then the macro landscape continues to warrant a "buy the dip" mentality.

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