Monetary Policy and Equity Trends

There have been two major US stock market trends frequently discussed in recent client and investor meetings: stock market concentration and the resumed leadership of growth stocks in 2023. The drivers and potential reversal of these trends are key topics within these discussions. There are many drivers of investor behavior and predicting the direction of that behavior over short-term periods is complex. However, the impact of monetary policy has been discussed more often than others.

Generally, investors would expect a positive relationship between future equity market returns and increasing money supply. Relatedly, an inverse relationship between future equity market returns and rising interest rates is expected. The underpinning of this relationship is that more accommodative monetary policy is aimed at motivating investors to increase their risk appetite and leads to asset inflation, both of which are potential contributors to rising stock prices and valuations. While this relationship is true in general, understanding the impact of monetary policy on different groups of stocks and market structure requires more nuanced analysis.

A quick review of the long-term correlations between stock market concentration and outperformance of growth stocks with changes in monetary policy yields a somewhat tenuous relationship. The table below shows the long-term correlations between the percentage weight of the top 10 holdings in the Russell 1000 Index, the 1-year return spread of the Russell 3000 Growth and Value indexes, and various monetary policy factors. While there appears to be modest positive correlation between these two equity market environments and the growth of money supply, weaker inverse relationships are observed with the Fed Funds Rate Level.

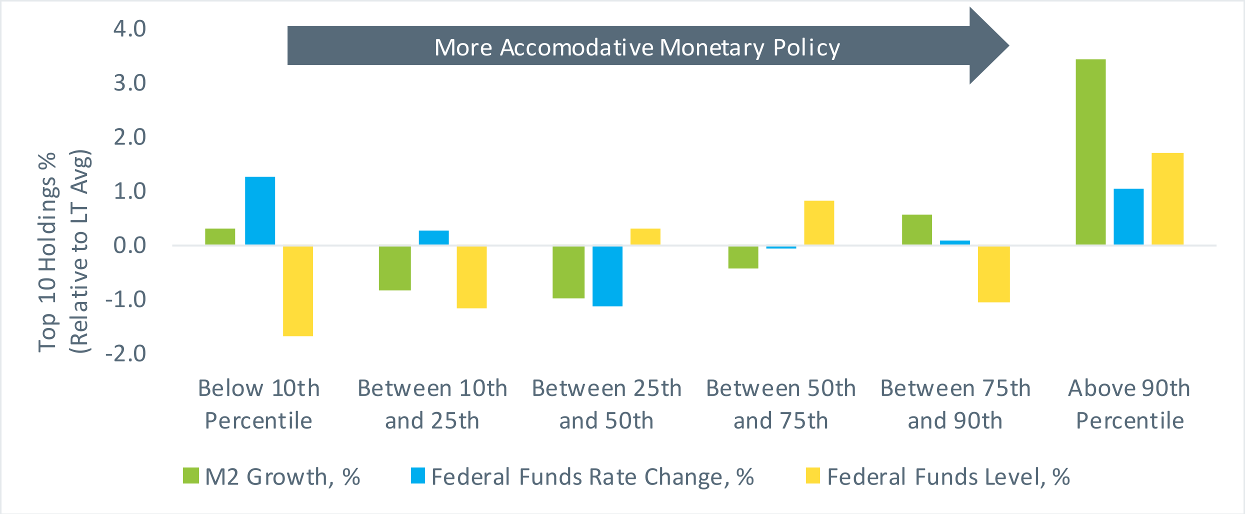
December 1979 - December 2023*	M2 Growth	Federal Funds Rate Change, %	Federal Funds Rate Level, %
Russell 1000 Top 10 Holdings, %	0.281	0.015	-0.175
Russell 3000 Growth - Russell 3000 Value Return Spread (1 Year, %)	0.177	0.010	-0.061

*Data is monthly except for Top 10 Holdings data which is quarterly prior to 1987.

Source: Federal Reserve Bank of St. Louis, Morningstar, and FTSE Russell

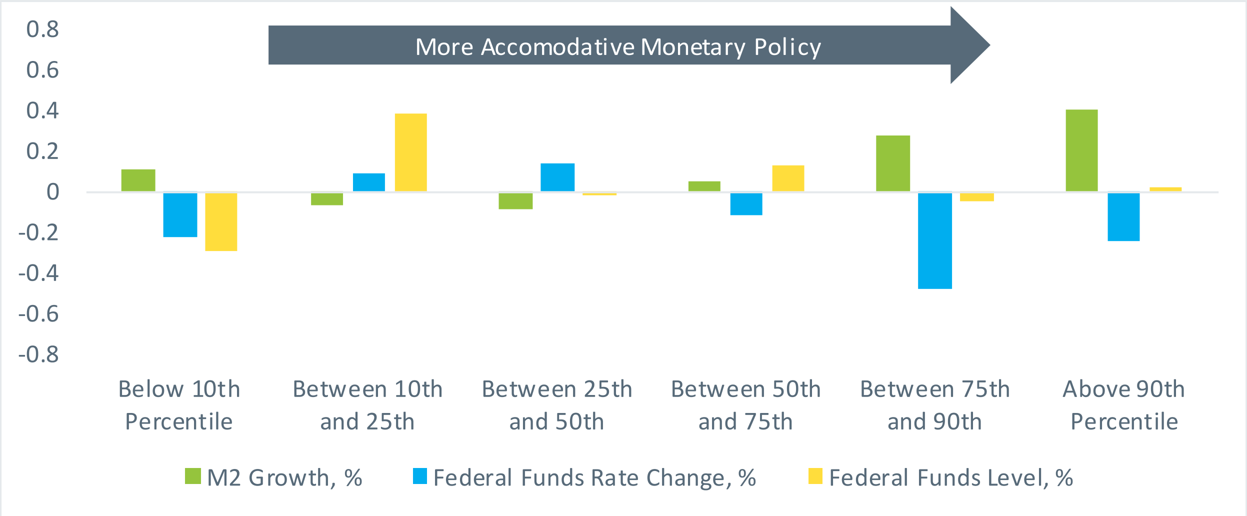
A closer review of the distribution of these relationships helps uncover periods when the monetary policy environment should be considered closely by investors. The charts below show stock market concentration grouped by the distribution of various monetary policy indicators (M2 money supply growth, year-over-year change in the Federal Funds Rate, and Federal Funds Rate level) and 12-month correlations within each grouping. For the purpose of illustration, the Federal Funds Rate and Level is sorted from highest to lowest, with more accommodative monetary policy represented by the "Above 90th Percentile" category. In practice, this shows that market concentration has been greater in periods with the lowest interest rate levels and highest money supply growth.

Figure 1: Market Concentration (Russell Top 10 Holdings, % Relative to Long-Term Average)



Source: Federal Reserve Bank of St. Louis, Morningstar, and FTSE Russell

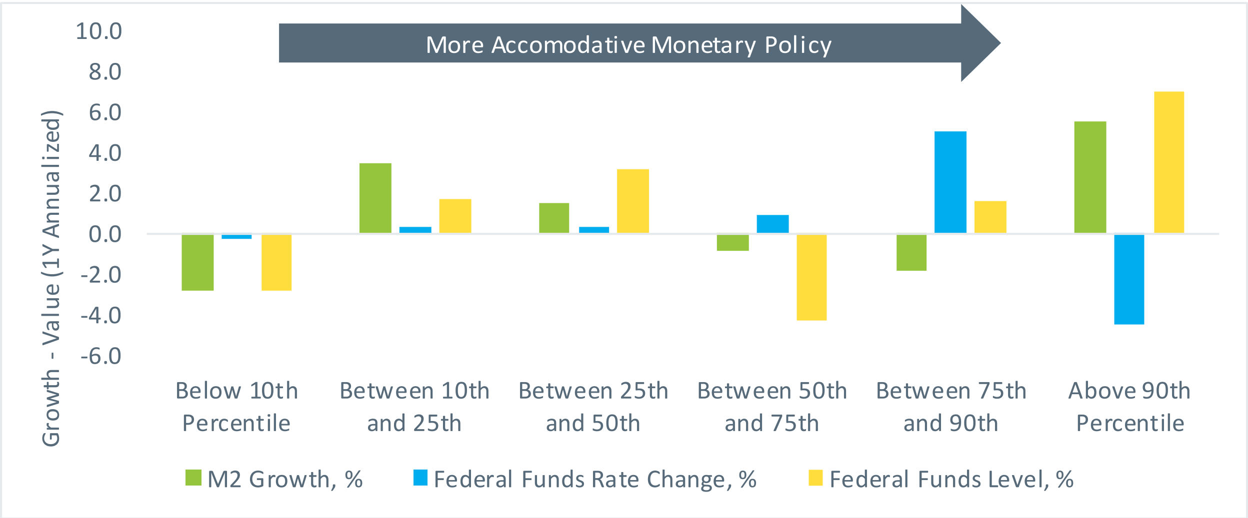
Figure 2: Correlations between US Stock Market Concentration and Monetary Policy Indicators



Source: Federal Reserve Bank of St. Louis, Morningstar, and FTSE Russell

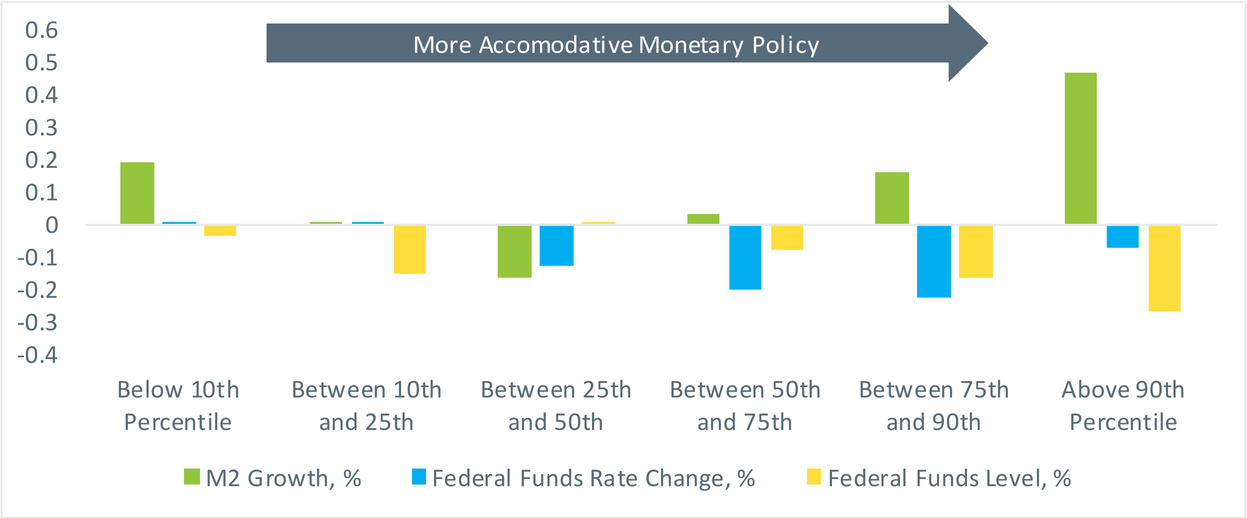
The impact on the style spread (growth – value) shows a similar trend. Generally, a lower interest rate environment with greater money supply has coincided with better returns for growth stocks relative to value stocks, and vice versa.

Figure 3: Growth-Value Spread Across Different Monetary Environments



Source: Federal Reserve Bank of St. Louis, Morningstar, and FTSE Russell

Figure 4: Correlations between Growth-Value Spread and Monetary Policy Indicators



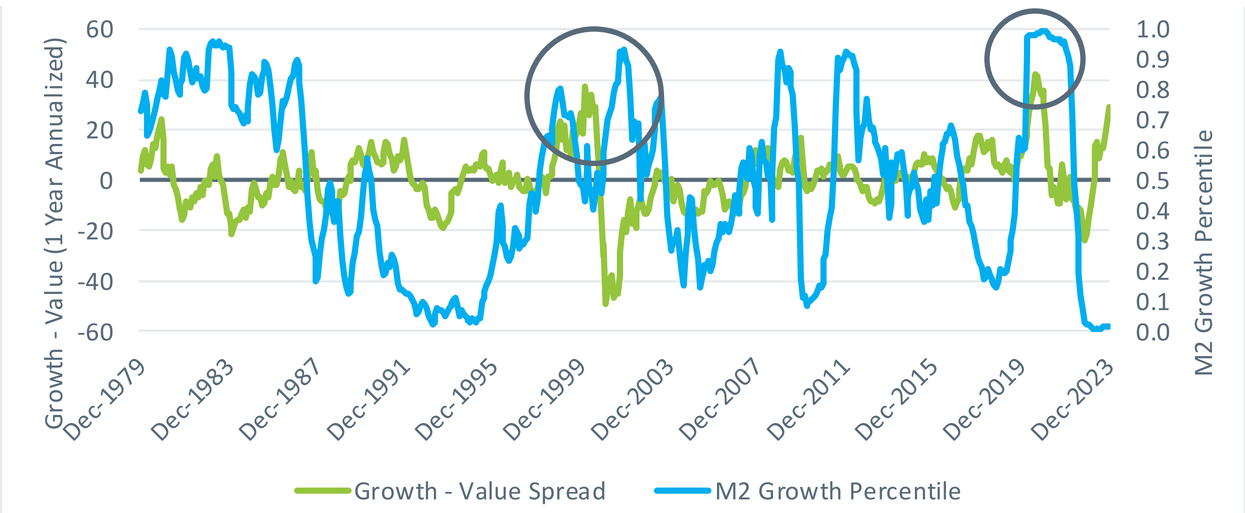
Source: Federal Reserve Bank of St. Louis, Morningstar, and FTSE Russell

Potential rationale for this relationship have been numerous; a summary of a few common theories is provided below:

- The lower discount rate for investors discounting expected long-term cash flows generally benefits the valuations of companies with longer-duration growth profiles.
- A reduced cost of capital will generally benefit companies reinvesting in an emerging or existing competitive advantage.
- Increased risk-taking by investors who become more willing to look out further and accept greater near-term volatility, generally favors companies with higher future growth prospects.

It is also worth rationalizing that there are specific periods when the impact of more accommodative monetary policy has coincided with growth stock dominance. Outside of the late 1990s and the more recent period, the co-movement of the style trends and money supply have been less evident. The below chart helps illustrate that these relationships can be tenuous, but important to understand and monitor when reacting to recent market trends.

Figure 5: Money Supply and Style Spread History



Source: Federal Reserve Bank of St. Louis, Morningstar, and FTSE Russell

For long-term strategic investors, the impact of these trends appears to matter most at the extremes. Correlations, positive or inverse, between the respective factors are greatest when money supply growth is highest and interest rates are lowest. This takeaway leads to a few considerations for institutional investors:

- Consider the headwind presented to investment managers who construct portfolios without a growth bias or reduced concentration in the largest companies within a respective index.

- Avoid overreaction to near-term style or concentration trends in extreme monetary policy environments.
- As money supply drops and rates remain elevated, it is reasonable to expect weaker trends in market concentration and the style spread—meaning more variable market behavior with fewer direct tailwinds or headwinds for investors focused on different market cap segments or style biases.

The long-term correlations of the included factors suggest these relationships ebb and flow over time. To be sure, other critical factors related to equity trends, including valuation levels, demographic shifts, or macroeconomic risks, also need to be incorporated into decision making. However, there are instances when it becomes increasingly important to consider the impact of the monetary policy environment when it is more likely that its relationship with equity market trends will strengthen.

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