The Pesky Stock Market

The Chicago Fed National Financial Conditions Index (NFCI) is a weekly measure of financial conditions. The series is designed to be all inclusive, capturing over 100 financial variables that measure the state of the credit, debt and equity markets as well as traditional and shadow banking. Monetary policymakers pay attention to it.

A neutral setting on broad financial conditions is when the series is zero. But when the series is above zero, financial conditions are tightening. The opposite is the case when the series is below zero, financial conditions are easing. Each one point increment from zero represents one standard deviation.

While the NFCI data extend back to 1971, we show a more limited history in the chart below to better isolate the impact of one series which appears to be dominant—the US stock market.

Remarkably, according to the Chicago Fed there have been few periods since 2017 when financial conditions were tightening. They occurred during the early stages of the pandemic from March 13th to May 8th and were not particularly serious. Tightness in the series peaked at just 0.43 on April 3rd, which was well inside one standard deviation.

Of course, this was due to unprecedented Fed actions—the funds rate went back to zero, new lending programs were created, and unlimited quantitative easing was enacted. As the chart demonstrates, financial conditions have been “easy” ever since because the series has not been above zero. In fact, the closest it got to being restrictive was last October at -0.07. But notice something else, which is even more important.

Over the last two years, the Chicago NFCI and the S&P 500 have been nearly perfectly inversely correlated. When stock go up, the NFCI goes down. The correlation coefficient between the two series is an incredible -0.92. This was not always the case as the correlation coefficient has been close to zero for full sample shown below. Recently, though, the trend in stock prices is effectively dominating everything else that is going on in the financial markets. This has important implications for monetary policy.

The Fed has repeatedly warned investors that it needs to tighten financial conditions to slow aggregate demand and bring it into better alignment with aggregate supply. However, the longer the stock market rallies, the likelier it is that broad financial conditions remain accommodative, thus supporting underlying aggregate demand and making the Fed’s job harder. Stay tuned.

Sources: Chicago FRB, Standard & Poors, Haver, SMBC Nikko
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