What Stops the Stock Market Rally?

In terms of magnitude and shortness of time, the stock market rally since its March lows has been unparalleled.

The Kitchen Sink

April, 2020

By late January, the die was cast: the virus had a name, it had reached our shores, travel screenings and restrictions were in place, and while not yet declared a pandemic, the World Health Organization declared COVID-19 a "Public Health Emergency of International Concern."

Yet complacency reigned within financial markets. The stock market continued its march to new highs (reached on February 19th). The Federal Reserve, in its January 29th press release, failed to mention coronavirus in the list of variables it "will continue to monitor" save for a generic nod to "global developments."[i] It began the missive by mentioning recent data "indicates that the labor market remains strong and that economic activity has been rising at a moderate rate." Famous last words.

It was not until a full month later, and only after the U.S. stock market suffered its worst week since the Great Recession, did the Federal Reserve act. It was rather weak work. On February 29th they issued a statement describing how they were "closely monitoring . . . the evolving risks of the coronavirus to economic activity."[ii] On March 3rd, they cut interest rates by a not uncommon 50 basis points.

But on March 15th, the Federal Reserve completed its year-to-date journey from satisfaction to concern to sheer panic. That Sunday's emergency announcement marked the first of several major measures meant to stop the bleeding on Wall Street and stem the tide of anticipated economic hardship.

The Federal Reserve's actions are unprecedented in both magnitude and breadth and will generate serious repercussions for investors down the road.

While the financial media widely reported how the March 15th actions lowered the federal funds target rate to 0.00-0.25%, it missed the far more drastic action of eliminating bank reserve requirements. Previously, banks had to retain 10% of demand deposits which meant they could theoretically increase the money supply by ten times. Now no limit exists to their monetary expansion.

March 23rd brought more unprecedented action when the Federal Reserve announced it was buying $375 billion in Treasuries and $250 billion in mortgage backed securities *that week*. For comparison, 2008's QE1 was $700 billion (comparable in size) and it took months to deploy. It also announced it would continue buying assets "in the amounts needed" to support the economy. It started buying, for the first time ever, corporate and short-term municipal bonds.

Then, on April 9th, the Federal Reserve announced $2.3 trillion in loans to "support the economy." Not content with corporate and municipal, it started buying junk bonds. It could have saved itself the trouble of buying various bond sectors by simply writing a check for most of the office real estate ($2.5 trillion), farmland ($2.7 trillion), or multi-family housing property ($2.9 trillion) in the U.S.

The Federal Reserve’s substantial and sustained efforts to pull the economy out of the 2008 Great Recession increased its balance sheet by $3.6 trillion in just over six years. It just added $2.3 trillion to its balance sheet *in a month*.[iii] This isn’t throwing the kitchen sink at a problem – it’s lobbing in the entire kitchen.

Even if the Federal Reserve stopped further actions and ceased its announced programs, its balance sheet will continue to swell as it finances proliferate spending by the U.S. Treasury. Given such actions as the CARES Act and its Paycheck Protection Program, the Congressional Budget Office estimates the 2020 deficit will reach $3.7 trillion – a multiple of anything seen in the wake of the 2008 Great Recession.[iv] This estimate will only increase with any additional spending initiatives by Congress.

Money supply has already exploded and is at the fastest rate in 92 months.[v] It is just getting started.

In response to 2008, the Federal Reserve increased the money supply dramatically, but much of that was held by commercial banks in excess reserves at the Federal Reserve where they earned some small, yet risk-free, interest. This time is different. Not just in magnitude, but in breadth, which is to say by recipient. No longer will money be injected into banks and primary dealers, but to companies and individuals who make up the economy as whole.

Inflation will ensue. Not right away, for the deflationary forces of loan repayments and defaults will counteract and potentially overwhelm inflationary forces. But that will be somewhat temporary.

Until then, it is an opportune time to build up inflation protections for an investment portfolio: certain types of real estate (e.g., farmland and some residential rental property), precious metals, and cryptocurrencies.

Endnotes:

1. Federal Reserve Bank of St. Louis. Timeline of Events Related to the COVID-19 Pandemic. https://fraser.stlouisfed.org/timeline/covid-19-pandemic#14
2. Federal Reserve Press Release. 29 Jan 2020. https://fraser.stlouisfed.org/title/federal-open-market-committee-meeting-minutes-transcripts-documents-677/meeting-january-28-29-2020-585165/content/pdf/monetary20200129a1
3. Federal Reserve Bank of St. Louis. Federal Reserve Total Assets. https://fred.stlouisfed.org/series/WALCL
4. "Coronavirus Relief Pushing U.S. Deficits to Staggering Heights" Associated Press. https://www.pbs.org/newshour/politics/cbo-says-deficit-to-reach-3-7-trillion-in- economic-decline
5. "Money Supply Growth Surges to 92-Month High" McMaken, Ryan. Mises Institute. https://mises.org/wire/money-supply-growth-surges-92-month-high

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SOMA for the Masses

Soma is a government-provided drug which helps people escape the real world by artificially enhancing their joy, arousal, and overall sense of well-being.

The Tariffying Prospect of a Trade War

If the trade war escalates, can it directly cause a U.S economic recession? Many mainstream pundits, citing the infamous Smoot-Hawley Act of 1930, warn as such.

Irrational Complacency

complacency (noun): a feeling of quiet pleasure or security, often while unaware of some potential danger, defect, or the like.

Defense Wins Games

Football fans always get excited about offensive prowess, but they also know that when it counts, it is the defense that wins games.

Lies, Damned Lies, and Government Statistics

There are three kinds of lies: lies, damned lies, and statistics. — Mark Twain, 1906

Commemoration of a Canard

In the spirit of commemoration, we cannot allow the 42nd anniversary of Nixon’s speech go without comment.