Fed policies spark more concerns over market collapse

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As money continues to pour into Wall Street, sending the three major markets indexes—the Nasdaq, the Dow and the S&P 500—to new record highs at the end of last week, there are mounting warnings that the lights are flashing red, signalling that the speculative bubble may soon burst, with major consequences.

The warnings come from within sections of the financial elite, as well as from financial analysts and media commentators, who are fearful of the consequences of the endless pumping of money by the US Fed and other major central banks into the financial markets.

Last week, Carson Block, the founder of Muddy Waters Capital, a New York-based investment firm, wrote an opinion piece in the *Financial Times* in which he noted that the recent GameStop boom and bust was "a wake-up call to policymakers that world markets and economies are precariously positioned, and pose significant risks to political stability."

He said the primary causes of the market dysfunction were passive investment funds and leveraged financial operations enabled by low interest rates. Passive investments do not operate through active decision-making, but via algorithms that follow market trends—buying when the market is rising and selling when it falls. In his view, this means that they tend to exacerbate swings in the market, either up or down.

Block wrote that it was "an increasingly obvious fact" that it was not known whether governments could perpetually bail out the markets. With interest rates hovering around zero, "the traditional levers of monetary policy may not be able to rescue markets and prevent another depression."

He continued: "The real risk to markets is that passive flows go negative (if widespread layoffs lead workers and employers to cut their 401K contributions). If that were to happen, passive fund selling would quickly overwhelm the market. Such a crash could resemble 1929-32 in magnitude, but at 2021 speed."

He concluded it was necessary to "find a way to deleverage our economies and markets," but did not offer a solution, saying that "governments seem to lack the will and competence to do hard things."

A *Bloomberg* article published over the weekend pointed to the rise of the so—called "Buffett indicator"—the ratio between the total market capitalization of US stock to the dollar value of the US gross domestic product (GDP). In 2019, it first crossed its previous peak, reached during the dot.com bubble at the turn of this century, and has now reached more than double the estimated GDP for the current quarter.

According to one market analyst cited in the article, the rise in the ratio "highlights the remarkable mania" in US markets, fuelled by the provision of virtually free money by the Fed. "Even if one expected those (Fed) policies to be permanent, which they should not be, it still would not justify paying two times the 25-year average for stocks," he said.

In a *Bloomberg* comment posted last week, financial analyst Mohamed El-Arian pointed to the disconnect between the economy and financial markets, which in the short term opened "a bigger window for significant additional fiscal stimulus to supplement ultra-loose monetary policy and financial conditions," but did so "at the risk of amplifying the policy, financial stability and political risks that await us down the road."

He warned that what might be favourable for fiscal policy and markets in the short term increased future risks, starting with financial stability. "The more Wall Street surges ahead in the short term, the harder it is for eventually improving economic conditions to validate the ever more elevated assets prices in an orderly manner."

Wall Street Journal editorial board member and columnist Joseph Sternberg took an historical approach in a comment published last week, recalling the hyper-inflation of Weimar Germany in the 1920s. He noted that hyper-inflation was only part of the way monetary excesses destroyed German society at that time.

"A consequence of chaotic financial markets [in Germany] was a new boom in speculation," he wrote. "The economic miseries of the era were not uniformly distributed, and the divergences between new classes of haves and have-nots stoked political and personal resentments alongside rampant corruption. Does any of this sound familiar?"

Western democracies over the past 15 years had not been functioning like societies where economic conditions are benign. "We are witnessing vicious political polarisation, rapidly deteriorating social trust, a breakdown in economic relations between generations—even peasants' revolts as varied as Brexit and GameStop."

Sternberg said confining debates over inflation to the level of the consumer price index was a "dodge." "Most of the social factors about which economists really care when discussing inflation, broadly construed, are flashing red."

Financial Times Associate Editor Rana Foroohar also referenced

Weimar Germany in a column published today. She likened the volatility in the gold price in German marks in the 1920s to bitcoin speculation today. She agreed with the formulation advanced by a financial analyst that Bitcoin was not so much a bubble as "the last functioning fire alarm" warning of major geopolitical changes ahead.

In an editorial last week, the *Financial Times* warned that the Fed had to be mindful of inflation worries as a result of the Biden stimulus, and added that its commitment to keep interest rates low until at least 2022 ran the risk of being "irresponsible."

This was followed by a significant comment from financial columnist Gillian Tett, in which she took aim at remarks by Fed Chair Jerome Powell in a speech to the Economic Club of New York last Wednesday, noting that the policy of the Fed appeared to be "if in doubt, double down."

Powell's speech was delivered in the wake of a widely discussed op-ed piece in the *Washington Post* by former Clinton Treasury Secretary and Obama economic policy adviser Lawrence Summers. Summers wrote that the Biden stimulus package could promote the kind of inflation seen in the 1970s, with consequences for the US dollar and for financial stability.

Powell said the Fed would maintain its "patiently accommodative" policies until the economy hit full employment and inflation had been running above two percent for some time.

"He also said that neither would appear soon," Tett noted. "In plain English, this means virtually free money is here to stay for a long time, never mind the inflation chatter. Think years, not months before policy changes."

This, she said, was a "mistake." But she went on to maintain that the Fed had been correct to introduce asset purchases and quantitative easing after 2008, to "ward off the risk of depression," and to intensify these policies when COVID-19 struck last year. These, however, are the very measures that have created the present situation.

She maintained that it was now time for the Fed to at least indicate that at some point it would call a halt, taking issue with the Fed's so-called "forward guidance." Previous generations of central bankers thought it "foolish to give excessively precise signals about future policy, as that would tie their hands or encourage market complacency, or both."

Over the past year, Fed officials have indicated that the present policy—ultra-low interest rates coupled with asset purchases of more than $1.4 trillion a year—will continue at least until the end of 2022, if not beyond. This was taking forward guidance to a "new level that seems dangerous," Tett said.

But the central question is how to bring an end to the present policy without precipitating a market collapse. And here the critics of the Fed have no answers.

Tett recalled the market turbulence in 2013—the so-called "taper tantrum"—when the then-Fed Chair Ben Bernanke indicated that quantitative easing, initiated in response to the 2008 crisis, might come to an end.

Powell, who at that time had only recently become a member of the Fed's policy-making body, recalled three years ago that "The taper tantrum left scars on anybody who was working at the Fed at that time."

In March of 2013, he had warned that the Fed's ultra-loose monetary policy, which has only been expanded in the years since, was prompting investors to make increasingly risky bets. In June of that year, Tett reported, he argued that while an abrupt change in policy could spark market turmoil, it would also be damaging "if investors conclude that serious consideration of reducing [quantitative easing] is postponed indefinitely."

According to Fed transcripts from that period, he said, "We find ourselves in a situation here where we're on the roof, and there is no risk-free path. We've got to jump."

In the present situation, the Fed chair no doubt also has in mind his experience in 2018. Powell enacted four interest rate increases, each of 0.25 percentage points, and forecast more to come in 2019, together with a wind-down of the Fed's asset holdings by $50 billion a month.

The market responded with a significant downturn—the worst December quarter since 1931 amid the onset of the Great Depression—and Powell immediately reversed course, cutting interest rates even before the pandemic struck.

Powell has sought to justify the present policy by insisting that it is aimed at assisting the poorest sections of society devastated by the impact of the pandemic. But, as Tett rightly pointed out, the cheap money regime increases inequality, raising the value of assets held by the rich.

Another factor, not mentioned by Tett, is that it leads to intensified exploitation—lower wages and worsening working conditions—in order to ensure the flow of ever higher profits to sustain the asset boom.

Tett wrote that Powell needed to find a "ladder" to climb from the roof, and should puncture assumptions that cheap money is here indefinitely. Otherwise, the present policy "will eventually unleash a new monster in the form of a bigger market tantrum, far more damaging than last time."

The historical record reveals that there is no such "ladder" to be found. The policy of ultra-cheap money was initiated in response to the October 1987 stock market crash. It was extended as a result of the series of financial crises of the 1990s and early 2000s, and intensified in response to the 2008 meltdown and the financial markets freeze that hit in March of 2020 along with the onset of the pandemic.

These developments demonstrate that the major economic institution of the capitalist state, its central bank, is now caught in the grip of an ever-tightening spiral. In order to sustain the mountain of fictitious capital created by its previous policies, it has to pump still more money into the financial system, seemingly in defiance of the underlying laws of the capitalist economy itself.

But those laws will inevitably assert themselves, not in a peaceful or gradual manner, but, as Marx explained, in the same way that the law of gravity asserts itself when a house falls about our ears.