Powell delivers reassurances to Wall Street

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Federal Reserve chairman Jerome Powell has reassured Wall Street that the central bank will continue pouring money into the financial system and keep interest rates at ultra-low levels well into the future, amid growing concerns the financial bubble that has seen the stock market reach record highs could come to a sudden end.

Powell's soothing words for the financial markets were the central thrust of his semi-annual report to Congress that he outlined to the Senate banking committee yesterday.

He began by noting that the rebound in economic activity taking place in the summer had now "slowed substantially," and that the economic recovery "remains uneven and far from complete, and the path ahead is highly uncertain." He said that, as with overall economic activity, "the pace of improvement in the labour market has slowed" and in the three months ending in January employment had risen at an average monthly rate of only 29,000.

Turning to monetary policy—the central concern of Wall Street—Powell was at pains to emphasise that the present regime would continue even if inflation began to rise and there was a tightening in the labour market. He noted that the Fed had made "some key changes" in its policy.

With regard to employment, one of those changes was that "we will not tighten monetary policy solely in response to a strong labour market."

On inflation, he said the aim of the Fed was to achieve averages moderately above 2 percent over time. "This means that, following periods when inflation has been running below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time." In effect, the present policy will continue for years.

This message was aimed at assuring the markets that if there were to be a spike in inflation, about which there have been warnings because of the Biden administration's proposed $1.9 trillion stimulus package, the Fed would not respond with an immediate tightening of monetary policy.

In addition, the Fed would continue to increase its holdings of Treasury securities and mortgage-backed securities "at least at their current pace until further substantial progress has been made toward our goals," noting that these measures have "materially eased financial conditions."

The Fed is currently purchasing these financial assets at the rate of $120 billion per month—that is more than $1.4 trillion a year. This amount is equivalent to around 7 percent of gross domestic product, a level of support never before seen.

Powell's remarks were music to the ears of Wall Street. There has been a slide over the past week in response to a rise in the yield on 10-year Treasury bonds to more than 1.3 percent, compared to the level of 0.5 percent that it hit in August last year.

Following his testimony, tech stocks made something of a recovery from a sharp decline earlier in the day when the tech-heavy NASDAQ index fell by as much as 4 percent before recovering to end the day 0.5 percent lower. The broader market remained basically steady.

Since the beginning of the year, there have been numerous warnings that Wall Street has entered a bubble phase and could collapse in the face on any sudden increase in interest rates.

The chief factor in the market rise has been the injection of money by the Fed and other central banks since last March. Then the financial markets froze before the Fed intervened with a new round of asset purchases and stepped in to act as the guarantor for all areas of the financial system.

According to a report in the *Financial Times* (FT), central banks have since injected $6.6 trillion of

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liquidity into the financial system with the expectation that they will provide at least another $5.8 trillion.

The effect of these measures has been to create a mountain of fictitious capital, financed by increased debt, which is extremely sensitive to even a small rise in interest rates in bond markets, particularly if they move sharply upwards.

A research note issued by strategists at the finance firm ING early this week, reported by the FT, said: "Should Treasury yields continue to rise too fast, it will bring everything else down with it. From here, slow and steady extends the party in [the] asset risk pace… while fast and furious ends it."

The effect of the intervention by the Fed and other central banks can be seen in the junk bond market, that is, corporate bonds that have less than investment grade ratings. A number of junk bonds have been issued in the recent period at 3 percent or below.

Two years ago, this was the rate on 10-year US Treasury bonds, regarded as one of the most secure assets in the global financial system. Today companies regarded as somewhat risk-prone can obtain money at the same rate.

So long as the Fed acts as the guarantor for credit markets, however, the lending continues as investors move into ever riskier areas searching for a higher rate of return.

"When that stops being the case," one unnamed banker told the FT, "we will have a very bad outcome. I think the day of reckoning, if we ever get there, will be cataclysmic."

As the head of Citi, Chuck Prince, said in 2007, little more than a year before the 2008 crash, while the music is still playing you have to get up and dance, and so the speculation continues.

Inflation is also a growing concern for financial markets because of its immediate impact on the bond market. Increased inflation tends to lower the price of bonds, lifting their yield, or interest rate (the two have an inverse relationship), thereby impacting on the stock market.

In recent weeks there has been a rise in basic commodities including oil, now trading at around $60 a barrel, copper which has reached a 10-year high, as well as iron ore and nickel.

One view is that inflation and a rise in bond yields are expressions of a nascent economic recovery and when the economy bounces back it will provide the foundation for the increase in share values since last March.

Such a scenario may have been applicable in former times when markets, at least to some extent, reflected developments in the underlying real economy. But the central feature of the past decade, and especially the past year, has been the ever-widening divorce between the two as profits in the financial system become ever-more dependent on speculation.

In an FT comment this week, financial analyst Mohamed El-Arian noted that the Fed's vacuuming up of securities at non-commercial prices had conditioned investors "to buy every market dip, whatever the cause, and allocate more capital into ever riskier investments,"

Among the "multiplying indications of excessive risk taking" were the proliferation of speculative special purpose acquisition companies [SPACS], the record pace of corporate debt issuance, and a surge in trading using borrowed funds.

SPACS, which have surged in the past year, are companies which make an initial public offering on the share market, not on the basis of some production activity they will undertake. Rather, they raise large amounts of money to take over another firm which has yet to enter the share market, enabling its shares to become part of the speculation.

El-Arian wrote that the Fed needed to "consider seriously how best to slowly lift its foot off the monetary accelerator." He warned that unless this were done, together with action to control the massive migration of risks from banks to non-banks, as well as measures to moderate excessive risk taking, "the greater the risk of financial instability undermining economic well-being."

But there is no sign of that happening. Rather, Powell's remarks yesterday indicate the Fed is completely locked into the speculative spiral it has played the major role in creating. It fears that even an indication that such measures are being contemplated could bring a collapse of the financial house of cards.

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