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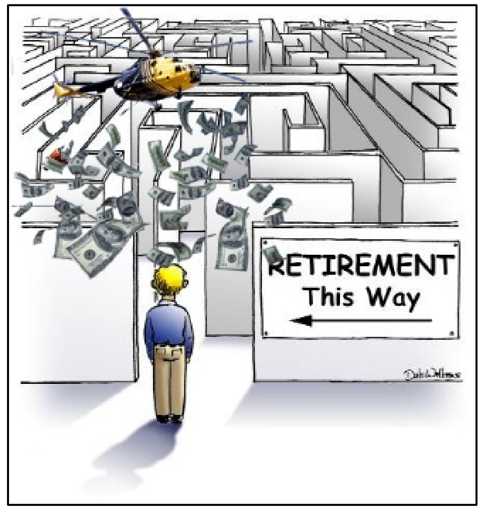
The Market Gods Must be Crazy

Navigating the Retirement Maze



"In theory at least, helicopter money could prove a valuable tool."
– Ben Bernanke, Federal Reserve Bank Chairman from 2006-2014 (1953 -)

Not too long ago, a good friend of mine asked a rather logical question: Considering that we're in the middle of a pandemic, many companies are suffering financially as are citizens, and there isn't a clear timeframe for all of this ending and things returning to normal… why is the stock market surging to new highs?

I told him that the answer, which probably wouldn't be satisfactory, seemed to come down to two things: The Federal Reserve ("the Fed") and 20-something day traders. Hard to believe? Read on.

Pennies… dollars… from Heaven

The phrase "helicopter money" was originally coined by the Nobel laureate economist Milton Friedman in 1969, when he used it as a hypothetical example of how dropping money from a helicopter would affect monetary expansion. Ben Bernanke used this analogy in a speech in 2002 indicating how using the Federal Reserve's money supply could be used to fight deflation if needed. When the 2008-09 real estate crisis hit, bank liquidity froze up, and it was up to the Fed to provide massive amounts of funds to guarantee that lending between financial institutions would still take place.

The credit crisis was averted, but rather than reducing its balance sheet over the next decade, it increased it, pumping still more dollars into the economy. At one point, Ben Bernanke confessed that the Federal Reserve had a third mandate – keeping the stock market afloat – in addition to its two legislated mandates, managing unemployment and inflation. Ultra-low Fed overnight interest rates contributed to the "easy money" era, allowing companies to buy their stock back and load up with debt that they believed would be easy to pay off. Fed monetary policy explains much of the run-up in the stock market over the past ten years, as studies have shown a high correlation between money supply and stock prices. Extremely low interest rates added to the appeal of stocks.

The COVID-19 crisis caught most businesses and individuals unaware. Companies closed, people were put out of work, and the unemployed lost their employer-based health coverage along with their paychecks. A necessary response to prevent the country from going into a deep depression and cash flow drying up was the CARES Act, the creation of $2 trillion pumped into the US economy. Additionally, the Federal Reserve increased the size of its balance sheet – the assets that it holds – by over $2 trillion by purchasing assets such as US Treasury bonds, forcing that additional amount of cash into the economy. Helicopter money forestalled a bigger disaster, though with long term consequences.

1999 all over again

The missing component for elevated stock prices is the stay-at-home 20-somethings with too much time on their hands, and the inability to spend their money on the usual items. Most of these newly-minted "stock market mavens" were children during the 1999 Internet stock craze when stock valuations hit excessive levels, particularly for companies that were not even close to generating a profit. I can still remember phrases like "eyeballs matter, not profits," and growth through eternity was baked into stocks' prices. Twenty years later, only a handful of these companies have survived.

Witness "1999 redux." Hertz rental cars declares bankruptcy in May, and yet the stock rockets 600 percent the following week. Never mind that in a Chapter 11 bankruptcy common stock shareholders typically get nothing once the negotiations between the company and the creditors are done. Traders somehow still thought that Hertz was a "buy," and bid it up. It has since fallen back to its initial post-bankruptcy level, yet even now common shareholders are unlikely to receive a nickel for holding onto shares.

The convenience of trading from one's cell phone, using apps like Robinhood and those provided by the major discount brokerages, makes it easy to play the market. These firms saw their new accounts grow by as much as 170 percent in the first quarter. Add to that zero cost commissions and the availability of fractional shares. Low margin interest rates makes it easy to double your bets on stocks, though if and when a day of reckoning comes for the markets, those same margin users will see their losses double along with margin calls requiring them to sell their shares at the worst possible time. Right now, it is mostly the tech darlings – Apple, Google, Microsoft, Tesla, Netflix – that have garnered most of the attention of these new traders. Never mind that few of them have any experience trading or valuing shares, their impression is that it seems to be a market where easy money can be made by anyone. That is enough to set off alarm bells for anyone who has been through past bear market cycles.

When the other shoes begin to drop

An upcoming election that is likely to see a regime change and consequentially a change to the tax laws is something that the markets don't seem to have factored in yet. But they will eventually.

So what should you do, the prudent, concerned investor who is staring at the financial assets that you have acquired over a lifetime of saving and investing? Pretty much what I have always said in the past: stay the course, manage your assets as though you need them to last a lifetime (because you do), and hold enough cash or low volatility short-term bonds to cover 3-5 years' worth of withdrawals from your assets if you are retired. The current situation is an anomaly, and anomalies eventually get corrected. Most experts didn't foresee a V-shaped market recovery, not with high unemployment, a virus that will take another year to eradicate or at least control, companies reporting poor earnings and sales, and bankruptcies that are likely to increase throughout the year. So rather than partying like it's 1999, do what Warren Buffett did back then: the same thing that he had been doing all along. Stick to your investing principles, avoid the chase for seemingly "easy money," and focus more on managing risk than returns. A year from now, you will be thankful that you did.

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