Another Financial Rescue by the US Fed*

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While forecasters grapple with predictions on the likely contraction in the world's leading economies, big finance, especially in the US, seems to be prematurely preparing for its next celebration. Recall that while the post-2008 Great Recession was precipitated by the financial collapse triggered by unbridled speculation in financial markets, the subsequent 'recovery' from the crisis saved and rewarded finance, but left the real economy limping and workers and the middle class poorer and often homeless. As the US and the rest of the world got accustomed to a new normal of slower growth, financial companies returned to profit, speculative agents had their bonuses restored and the New York stock exchange experienced the longest bull run in its history.

Unlike that crisis, the current 'Greater' recession that the Covid-pandemic has precipitated did not originate in the financial sector. But as the real economy contracted, finance too suffered a blow, with the S&P 500 for US stocks falling by almost a third to 2237 over the month ending 23 March. That was as it should be. With major companies experiencing a collapse in revenues and profits, stock prices had to retreat from the inexplicable heights they were ruling at before Covid-19 struck. The surprise element is what followed, with the S&P 500 rising from just above 2200 on 23 March to almost 3,000 two months later. Participants in this market seem to have escaped the grip of a crisis, which was only intensifying in the rest of the economy. The recent revival occurred in a period when production was at a near halt and unemployment soared in the US, leading to predictions of one of the worst economic contractions since the Great Depression. Big heads have rolled outside the financial sector, with marquee names like fashion retailers Neiman Marcus and J Crew and car rental major Hertz filing for bankruptcy. Sensible observers have for long held that the stock market's performance is no indicator of a nation's economic health. But this degree of divergence between the financial and non-financial segments of the economy seems to support the view that the nature of finance has changed so much that the fortunes of finance capital have been almost completely detached from the performance of the rest of the economy.

What is remarkable is the similarity of the recent performance of the US stock market with that recorded after the 2008 global financial crisis. An analysis by Bloomberg and Morgan Stanley Research reported in the media found that, allowing for differences in absolute levels between two points in time separated by more than a decade, the rebound of the S&P 500 index from the bottom it touched in both those crises reflects a similar trajectory. It is almost as if the market has found itself an "automatic stabiliser", even when the real economy lacks one of similar effectiveness, despite all talk of stimulus spending in the US and elsewhere in the developed world.

It is useful to examine the different reasons that have been advanced to explain the unusual recent performance of stocks indices in the US. The first and the most favoured argument is that since the pandemic and the crisis that followed affected all countries and pulled down stock values, investors exited from markets worldwide, especially emerging markets, and sought safety in dollar denominated assets, including US stocks. With the dollar being the world's favoured reserve currency, the flight to safety to the US of wealth holder capital is to be expected. What is not obvious is why that capital should find its way in uncertain times to the most volatile of instruments, namely stocks, as opposed to being parked in safe, especially government, securities.

An explanation offered for such 'risky' behaviour, is that the S&P 500 is really driven by a few large, especially so-called 'tech' companies, with considerable resilience. Some of them may have fared better in the lockdown period when online activity, including interaction through the internet, streaming of entertainment content and e-commerce, surged. Given the boom in this niche, the platform majors and companies that can ride on digital connectivity may have been attractive destinations for investors rushing to the US, resulting in a spike in the values of stocks that influence the movement of the aggregate index. However, the available evidence suggests that the post-crash buoyancy in stock prices in US markets is broad-based, even if not comprehensive in coverage. It is definitely not restricted to tech stocks alone. For example, the Bloomberg-Morgan Stanley analysis referred to earlier found that the number of stocks trading above their 200-day moving average had risen significantly in the course of the recent market revival, suggesting that the revival was relatively broad-based.

While these explanations for stock market buoyancy seem inadequate, there is a more convincing one suggested by the timing of the reversal of the S&P 500's decline. The index bottomed out and began its climb on 23 March, or a week after the Federal Reserve launched a series of unprecedented steps it claimed were needed to counter the Covid-induced economic crisis, but which by all accounts was a panic response to the disruption in bond and equity markets. On Sunday 15 March, the Fed's Open Market Committee, that met three days in advance of the scheduled date, decided to cut its policy rate, which influences the rate at which identified institutions can borrow, by a full percentage point to the 0-0.25 per cent range. Observers linked the Fed's decision to the 10 per cent fall in the value of US stocks three days earlier. With the Covid-crisis only having begun, market expectations were that the United States would be the next developed market economy to experiment with negative interest rates.

Along with the rate cut in mid-March, the Fed announced a series of liquidity enhancing measures including the purchase of an additional $700bn of assets, enhancement of its repurchase operations where it lent against securities for short periods, institution of new dollar swap lines with foreign banks to address dollar-funding shortages in international jurisdictions that may trigger sales of dollar denominated assets and disrupt financial markets, and a new credit facility that would help commercial banks to lend more to households and businesses.

While the Fed's actions were justified as being a response to the economic crisis precipitated by the Covid-induced sudden stop in economic activity, liquidity infusion in a time of crisis mainly helps financial institutions facing asset value and profit erosion. Access to zero-cost capital allows for positive and even significant returns from investment in assets that would not have been attractive enough in normal times. This helps companies to stay afloat without resorting to distress sales of existing assets in a broken market. As the volume of such new investment rises, so does the market and the stock index, independent of what the real economy signals about the likely profitability of the firms whose stocks are included in that index.

Having launched on this trajectory, and seen its salutary effect on stock indices, the Fed decided that its initial intervention was not enough. On April 9, the Fed built on its earlier initiatives and announced an expansion and modification of its bond-buying programme (quantitative easing) aimed at infusing liquidity into the system. To start with, it declared that there would be no limits on the volume of bonds it could buy in any single period, say a month. Second, it announced that it would no more restrict itself to buying government (Treasury) bonds and government mortgage bonds, accepting corporate bonds as well. Third, it said it will not restrict itself to buying only from the banking system whatever it does buy, and is willing to buy bonds directly from corporates or from secondary markets in an effort to stabilise markets and support corporate financing. That was a major shift in policy for a central bank that normally mediates its intervention through the banking system that it regulates. Finally, it will not restrict itself to buying only safe government bonds or highly rated corporate bonds, but will also take on low rated or junk bonds as well. This transformation of the permitted target of the Fed's purchase programme gave new meaning to its decision to lift any (self-imposed) limits on its bond buying. The Fed had declared that it was willing to keep pumping liquidity into the system even if that meant accumulating low quality paper and putting its own balance sheet at risk.

With much near-free money sloshing around, and the promise to release even more to support the corporate sector and financial system, it could be expected that setting aside their fears, investors would turn to stocks. Even if the promise of dividends is minimal given the effects of Covid-induced crisis, hopes of a marginal appreciation in value would make easily-acquired stocks an attractive target when the economy is collapsing all round. This seems to largely explain the paradoxical absence of any correspondence between the performance of the financial and non-financial sectors.

The Fed's action did contribute to the 32 per cent rise in the US S&P 500 between its low on 23 March and its value on 22 May, which wiped out the losses suffered over the month ending 23 March. Yet it would be wrong to suggest that the Fed's unprecedented intervention, which has been labelled "QE Infinity", was expressly aimed at reviving stock markets. Besides operating with the misplaced assessment that the availability of free money would be adequate to revive an economy damaged by a combination of a pre-Covid slowdown and Covid-induced sudden stop, the Fed was clearly addressing a weakness in the US economy that had developed during the years of the Great Recession. That weakness is a sharp increase in corporate debt, including borrowing by already highly leveraged corporations, and in derivatives built with such debt as backing.

John Cassidy of The New Yorker reports that the total debt of non-financial corporations rose from $6.1 trillion to $10.1 trillion between the fourth quarters of 2009 and 2019. A chunk of this debt was high risk and low-rated debt, with leveraged loans or credit provided to already indebted companies whose issues are rated below investment grade rising from $554 billion to $1.2 trillion between 2007 and 2019. But the appetite for such debt rose as they were bundled into "collateralised loan obligations", or derivatives built by slicing and dicing these bundles to make some of the tranches eligible for AAA ratings. As in the case of the sub-prime mortgages, mortgage backed securities and collateralised debt obligations that were accumulated before the 2008 crisis, this stash of risky corporate debt and debt-related paper exists on the assumption that default rates are likely to be low.

But Covid-19 has undermined such assumptions, as indebted companies find they cannot produce any more and are unlikely to be able to return to normal levels of capacity utilisation in the foreseeable future, leaving them without the revenues needed to service their debt. As their debt payment commitments fall due, they would have to declare bankruptcy, as Hertz has done or strip and sell-off assets at low prices, setting off what could be a deflation in asset prices that drags the economy into severe recession. What the Fed has done this time is to offer to take some of this debt onto its own balance sheet, changing policy and buying directly from corporations that were considered investment grade before the current crisis, with the knowledge that any losses it may suffer can be managed by churning out extra dollars from the mint. It is not clear how far the Fed would go in this direction. As of now the beneficiaries of its largesse are the big players. The Financial Times reports that investment grade US companies have borrowed a trillion dollars in the first five months of this year, as compared with $540 billion in the corresponding period of 2019. Borrowing has exceeded $200 billion in each of the three months ending May 2020, with big firms like Boeing, Oracle and AT&T topping the table of debt issuers. These firms too are affected adversely by the crisis, and, in Boeing's case, much else. They are using the opportunity to build a low cost stash (average yield 2.6 per cent) that can possibly help them survive through the crisis and return to normal business, if and when the crisis ends.

Thus, there are two ways in which the Fed's actions are seen as averting a financial meltdown triggered by the Covid pandemic. One is to infuse large volumes of low cost money into the system, allowing investors thirsty for some profit in a period when the economy is tanking, to remain active. That reverses the downturn in the stock market and leads to a complete lack of correspondence between trends in that market and the non-financial sectors of the economy. But this seems to be the collateral effect of what is perhaps the real motive for the Fed's intervention. That is to dampen the external effects of the Covid-induced real economy crisis on a financial system that did not learn its lessons from the Great Financial Crisis, and over-lent. Those effects threaten to set off a wave of bankruptcies, financial insolvencies and another Great Recession or Depression. The Fed's cure for this weakness resulting from a speculative amassing of debt, seems to be more debt.

Of these two consequences of the Fed's actions, stock market trends suggest that the Fed has done well on the first count. But there is as yet inadequate evidence that it can swing the second of its objectives, failing which even the first would fail. In any case, even if the Fed is successful here, it would have saved finance and financialised corporations, but not businesses that must earn their revenues by selling their wares and those who need work to take home their wages and salaries. That too is a repeat of a story told not so long ago.

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