RISK RISING | Investors taking on more equities

FED POLICIES COULD BOOMERANG

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COMMENTARY

The Federal Reserve appears to be setting the economy up for another fall, and normally risk-averse investors are playing along in a dangerous game.

Risk assets include equity capital and other assets with much higher than average risk. And it appears that investors in this environment are exceeding their normal risk tolerances. If the markets crash again, these overexposed investors will lose more than they are either psychologically or fiscally capable of bearing. Why?

Critical factors include:

Yield is virtually zero on debt instruments. Net of inflation, return on U.S. treasuries of less than 10-year duration is negative under current Fed policies.

Market yield is insufficient for retired investors to live on without eating into their principal, tempting even risk averse investors to move into risk assets.

Further tempting risk-averse investors into securities too risky for them are enormous money injections by the Fed to "stabilize" the system, equaling about $85 billion per month to create this illusion of stability.

English economist Alfred Marshall states in his "K" Theory that if more money exists in the money supply of an economy than that economy needs to operate, the excess money will flow into the financial markets, inflating them. The process works in both directions.

To "stabilize" the financial system in the fall of 2008, the Fed, for the first time ever, tripled the monetary base in 15 months. Similarly loose monetary policies caused the housing and investment markets to boom, then crash, destabilizing the financial system. Following Marshall's K theory, the excess Fed-created money flooded into the financial markets.

The financial markets consist primarily of the debt (bond) and equity (stock) markets. Writers I trust have always asserted that the bond markets were roughly 10 times the size of the equity markets. Even the money the Fed created could likely be absorbed smoothly by the combined markets without massive distortions of values.

Except for 2008-2009. Beginning interest rates were so low that the Fed's massive money injections dropped the overnight Fed funds rate to around 0.125 percent, and 10-year treasuries dropped to around 2 percent. Once bond market rates became so low that investments provided less yield than investors required, investors began moving into risk assets.

Thus was born "Super K" — a supercharged Marshall theory effect. As investors bypassed the now meaningless return from the bond markets, the risk assets markets, particularly equities, received proportionately much more than their expected, traditional 9 percent of the money supply excess. Such extreme money inflows into risk assets had the initial effect of inflating the equities markets much beyond normal. And remember, the Marshall K effect works in both directions.

So if the Fed slows or stops providing excess liquidity, equity prices will fall and the economy will contract, probably in the form of a crash. In spite of historic monetary stimulus from the Fed and unprecedented amounts of federal spending over a period of years, the economy has clearly *not* shown that it can expand on its own. The government clearly doesn't believe the economy is self-sustaining. Otherwise, why would policy officials continue massive deficit spending and monetary stimulus that threaten a crash of unprecedented proportions?

If the Fed continues existing policies, they will extinguish any true economic expansion. Inflation has been dampened only because of massive declines in money multipliers. In other words, all the money the Fed has pumped into the economy has circulated at a below-normal rate.

But true economic expansions always show money multiplier expansion. So should a true economic expansion start, the circulation of all the stimulus the Fed has put out could trigger massive inflation. Or the Fed would withdraw money from the money supplies to prevent this, raising interest rates. Either course — significant inflation or increased interest rates — would snuff out any nascent economic expansion before it becomes self-sustaining.

Sadly, the Fed has painted us into a corner.

Callom B. Jones V owns Trend Capital Management LLC, a Registered Investment Adviser in Overland Park. A longer version of this article appears as the February 2013 Newsletter at www.TrendCapitalMgmt.com.