March 2, 2020

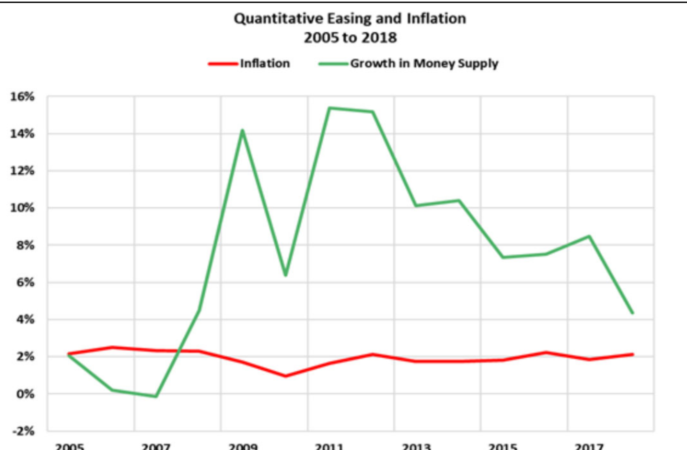
Victoria Capital Management, Inc.

Market Musings

A newsletter brought to you by Victoria Capital Management, Inc.

VOL. 3, ISSUE 3

The chart to the right shows that despite massive quantitative easing after the 2008-2009 financial crisis, inflation (CPI) did not budge even as economists feared that such increases in the money supply (M1) would be inflationary.
(source: FRED)



Is Quantitative Easing Enough?

According to Wikipedia, "Quantitative easing (QE), also known as large-scale asset purchases, is a monetary policy whereby a central bank buys government bonds or other assets in order to inject liquidity directly into the economy." The term gained interest when the Federal Reserve injected enormous amounts of reserves into the economy when it purchased mortgage-backed securities in 2008. When the Fed continued such purchases, the actions were dubbed QE2, QE3 and so forth. The action by the Fed was essentially to provide a safety net that truncated the shock of a mortgage security collapse across the economy as institutional investors were forced to mark their investment portfolios to market -- thereby lowering the value of these securities and threatening many of these institutions with bankruptcy.

What effect does QE have on the economy? The initial fear was that the "monetary explosion" would produce runaway inflation resulting in an economic meltdown. In 2009, a well-known economist said the following in the Wall Street Journal about the effects of QE: "But as bad as the fiscal picture is, panic-driven monetary policies portend to have even more dire consequences. We can expect rapidly rising prices and much, much higher interest rates over the next four or five years, and a concomitant deleterious impact on output and employment not unlike the late 1970s."

The QE policy resulted in a tax increase on the private sector as the interest earned on those mortgage securities was transferred from the private sector to the Fed. As the Fed's expansive low interest rate policy spread around the world as a "cure" for a weak global economy, the policy had the reverse effect and many economies were soon tottering on recession. Foreign central banks implemented a policy of low or no interest rates thus depleting interest payments in the private sector. This lack of income to the private sector may have slowed spending leading to an economic slowdown.

Once foreign central banks realized that monetary policy alone wasn't working, they started to move towards a stimulative fiscal policy solution that reduced tax rates resulting in encouraging results. Slowly, foreign central banks have been renouncing low interest rate policies while the politicians lowered tax rates and increased spending. As a result, we should see global growth rebound over the next few years barring any exogenous shocks to the system.

"Compound interest is the eighth wonder of the world. He who understands it, earns it; he who doesn't, pays it."

Albert Einstein

Market Commentary

The coronavirus dominated financial markets in February, reversing the continued bull market advance in stocks while bond prices continued to surge. Interest rates fell with the 10-year government bond yield setting a record low of 1.13%. The spread of the virus and the negative impact on global economic activity encouraged speculators to wait on the sidelines until the viral storm blew over. Since history tells us that such events are temporary in nature, long-term investors were wise by not panicking and saying, "this too shall pass". Did you ever think of who was on the other side of those trades? Could the Fed step in with its infinite checkbook and scoop up some shares indirectly during the panic?

During the nearly 11-year bull market that began on 3/10/09, the S&P 500 index has had 7 separate "corrections" of at least 10% but less than 20%.

(source: BTN Research).

Market Musings represents the views and opinions of VCM and does not constitute investment advice, nor should it be considered predictive of any future market performance. Data are from what we believe to be reliable sources, but cannot be guaranteed.