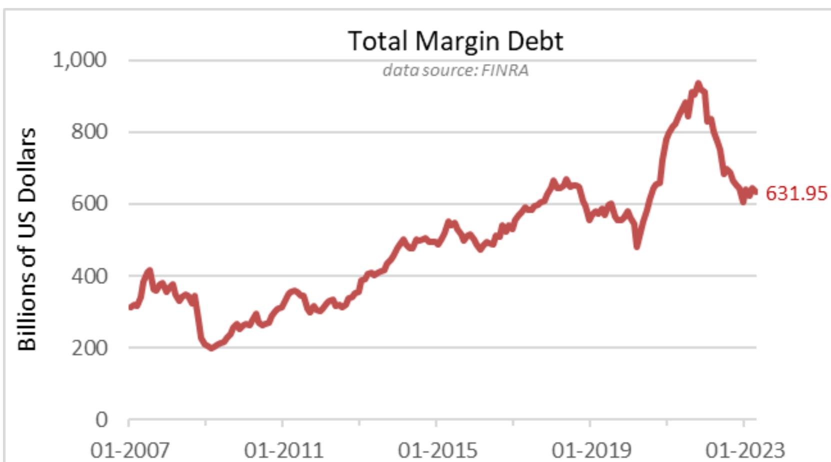
Sorry Gamblers: The Casino is Closed

May 22, 2023

One of the intended benefits of a tight monetary policy is the impact that such a plan has on speculators. As we look back on the massive policy stimulus to avert an economic crash in 2020, we can see that the printing of money caused an enormous increase in risk-taking. Couple that with record low interest rates and the scene was set for the gambling event of a lifetime wooing speculators across the world to invest in vehicles such as NFTs, SPACs, and cryptocurrencies. The elimination of commissions on stock trades (years ago) along with a next to zero cost to obtain margin on brokerage accounts created a casino-like environment for wheeler dealers. These "investors" could borrow money from many sources at record-low interest rates and buy and sell these conduits with the goal of becoming rich. The odds of winning were much better than sitting down at a craps table in Las Vegas given that "meme" stocks were leading the way and everybody wanted in before it was too late. NFTs and SPACs were a little more difficult for the average investor to get involved with, yet the average person had no problem buying and selling various forms of cryptocurrency. The huge market rally of 2020 in speculative stocks was fueled by these risk-takers and their day-trading added enormous volatility to financial markets.



The Federal Reserve's rapid increase in interest rates had a chilling effect on borrowers but an even greater impact on speculators. As interest rates rose so did the cost of money. From near-zero borrowing rates to recent margin loans at rates of 11.50% to 13.25%, gamblers could not afford to speculate. The chart above tracks the collapse in margin debt from record levels. One implication of this collapse is that speculators may no longer be driving the volatility in financial markets. In recent weeks, stock market volatility has dropped dramatically even in the face of major financial upheavals. The banking crisis will further limit the availability of loans for risk-taking—hopefully reducing the average investor's anxiety about investing in financial markets. Today, stock markets should be more sensitive to traditional issues such as earnings, revenues, dividends, and various economic metrics rather than on the caprices of wheeler-dealers. If this observation is correct, volatility as measured by the VIX, could remain low – and that is a good thing given that we are soon entering the volatile summer months.

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