Domestic Credit by Steve Parsons

Fed panics, cuts discount rate

The stock market is inflated, a huge cash shortage is evident, and the central bankers are running scared.

On Friday the 13th, the Federal Reserve cut its discount rate by 0.5%. White House press spokesman Marlin Fitzwater promptly announced: "It's good news. I don't think there's any doubt we're coming out of the recession."

But while President Bush and Fed chairman Alan Greenspan regale the media with tales of how this will spur the "sluggish" recovery, the truth is that a desperate Wall Street and the corporate sector have been screaming for "easy money" to staunch their hemorrhaging red ink.

"The discount rate drop is a sign of Fed panic," reports a leading European banking source. "It doesn't know what to do other than to keep lowering. It's becoming ominously similar to what occurred in the early 1930s."

Or, as Mellon Bank chief economist Norman Roberts put it with droll understatement: "I sense a growing sense of anxiety about the strength of this economic recovery. In many ways, the recovery is indistinguishable from the recession."

As October looms, a panic is indeed beginning to grip investors on Wall Street. On Sept. 10, the headline of the *Wall Street Journal*'s "Money and Investing" section blared: "Autumn: A Season for Stock Investors to Beware?" "Attention investors," the story begins, "You have entered the autumn danger zone. . . . Several market veterans predict that this autumn, leaves won't be the only thing falling. Six of the 10 biggest single-day drops in U.S. market history . . . happened in October. . . . Years with October crashes or massacres 'were generally bull-market years in which you got to the fall and had an overbought market,' " said one analyst. "That pretty much describes this year, too. 'I think we're setting up for a decline.' "

There are two main reasons. First, the stock market is overripe for a nosedive, even more so than when it crashed in October 1987 and October 1989. Over the summer months, the market attained all-time highs. The "values," or prices, of stocks are now far above the average of recent years, and way beyond a level appropriate to companies' earnings. In recent months, stocks have been trading at 18-20 times their earnings (the price/earnings ratio), as compared with a five-year median of 14.9 times and a 10-year median of 13.1 times. And this is happening when their overall earnings potential is growing bleaker by the minute.

The line being retailed to the suckers is that this isn't worrisome. A crash *can't* happen, because this high valuation is coming at the *end* of a recession, and stock prices are sure to go up. Therefore, investing in stocks now, while the "values" are relatively low, is a sure thing.

Even more significant than the absurd speculative overvaluation is that institutional investors—major pension funds and corporations—now have the lowest levels of cash since at least 1980: 4.4% of assets, according to a survey by Indata of more than 1,200 institutional investors. That means, in short, that the funds to fuel the overheated market just aren't there.

Ironically, this is primarily *because of* low interest rates. For months now, these institutions have been pulling their money out of liquid investments like bank certificates of deposit and Treasury securities, which have been paying lower and lower interest as rates declined, and have been injecting it into higher-yielding areas like stocks and junk bonds. It's this money that has artificially boosted the stock market.

Now this one-shot source of liquidity has dried up, prompting the Fed's discount rate cut to 5%, so that corporations can borrow more money more cheaply to stoke market investments. The rate cut, however, won't amount to a hill of beans. For example, the extra $34 a month from lower mortgages that each household will now have available to spend, translates to just over $1 billion monthly—a negligible increment in the $2 trillion of annual consumer expenditures.

Another irony is that because these investors have liquidated so much in bank deposits, banks are short of liquid funds to lend! This has contributed to a liquidity crunch for the economy, with banks increasingly unable to lend to businesses and consumers. And this is causing a drop in both business and bank profits, thus further depressing the economy and shrinking available funds even further. A vicious spiral downward has taken hold, which cannot be halted no matter how much further interest rates are cut.

On top of this, corporate and government agency debt issuance has soared, sopping up even more cash that would otherwise be available to the market. Last year, corporations issued $185 billion of domestic debt; corporate borrowing this year is already over $200 billion. Government agency debt so far this year is $133 billion, equal to entire amount of 1990, and ten times the $13 billion borrowed in 1986.

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