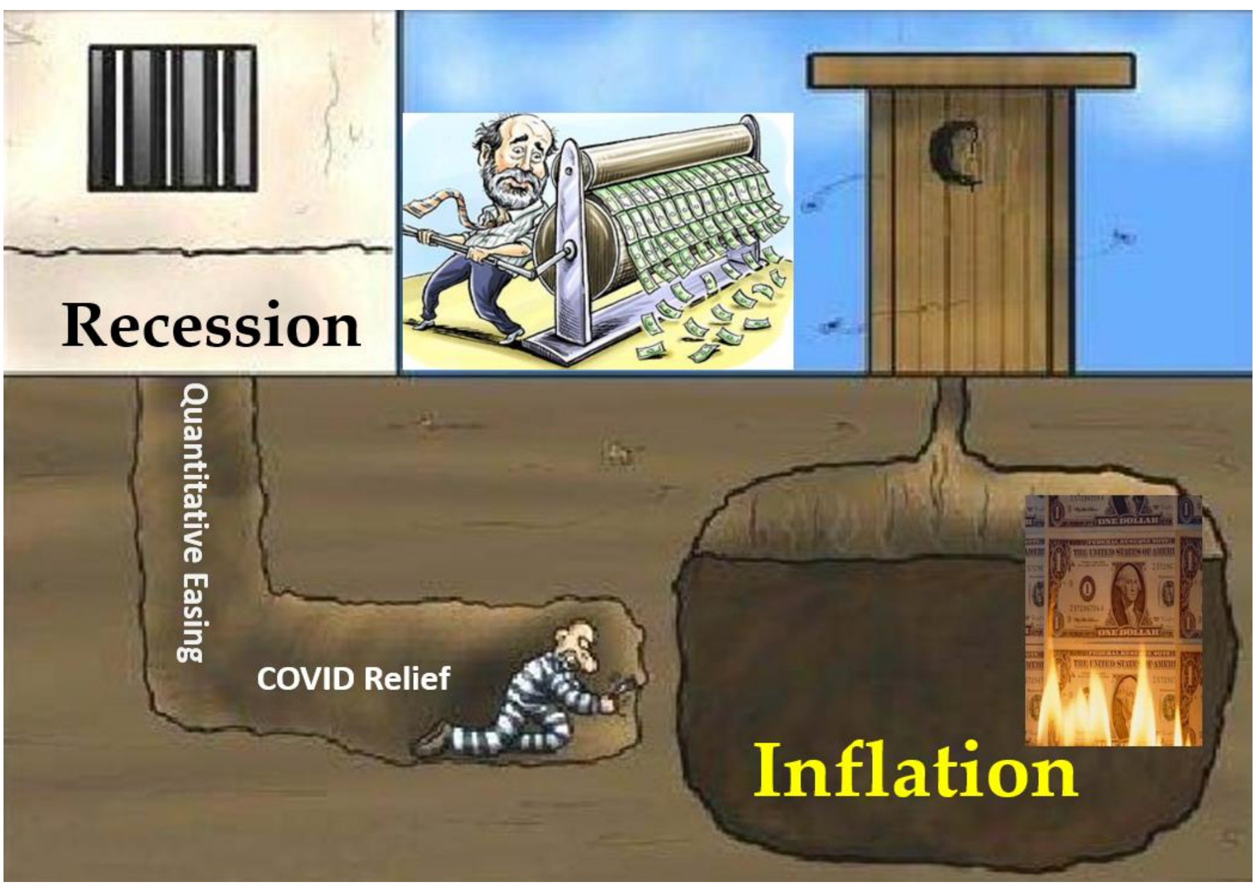
What Does it Cost to Rescue a $22 Trillion Economy?
The Good, the Bad and the Ugly of Federal Reserve Rescues

- Most applaud Federal Reserve rescues and are relying on them to prop up our stock and bond markets. Hurray Fed!!
- These rescues are simply money printing like the world has never seen before. That's bad.
- We may be sacrificing our future in order to ease our current pain. No one knows how much money printing is too much. It could get ugly. Billionaires could become penniless.

The Federal Reserve (Fed) rescued the economy from total collapse in 2008 and now it's stepping up again to rescue victims of the current pandemic. The Fed is our hero, but before we order that Superman cape, we need to be aware that there are costs that we all will pay for these rescues. Ambulances do not show up for free. As shown in the following picture, the Fed tunneled us out of recessions but the money printing that was necessary is likely to lead us into serious inflation. It's complicated, and many will not agree with my concerns, which is good – let's discuss.



The Good

2008 Financial Crisis

Due to the housing loan crisis, the gears of the economy were locking up, and heading to a total collapse in 2008. The Fed came to the rescue with Quantitative Easing (QE) that pumped $4 trillion into the economy and is credited with creating the longest bull market ever in stocks. We had a quick recovery from a recession and market crash.

COVID Relief

In addition to the catastrophic loss of human life, the COVID-19 pandemic has crippled many industries and put millions out of work. People are struggling to buy groceries and pay their bills. Enter the Fed with $3 trillion of relief in 2020 and another $3 trillion coming in 2021, most of it in "helicopter money" sent to almost everyone. This humanitarian relief is much needed; that's the "good."

Interest Rates

The Fed has manipulated short term interest rates to their lowest levels ever. This has caused increases in stock prices and made borrowing attractive, especially for share buy-backs and home mortgages. So, what could go wrong?

Shiller Price Earnings (P/E) Ratio for the S&P 500 vs. Long-Term Interest Rates

Cyclically-Adjusted P/E Ratios are 38% higher than the long-term average, suggesting that market valuations are stretched.

Source: 361 Capital

The Bad

2008 Financial Crisis

The "solution" to the 2008 crisis has its roots in Modern Monetary Theory (MMT) that advocates money printing to grease the economy but cautions that the printing needs to be reversed if and when inflation builds. The reversal mechanism is taxes. Do you think there's political will for large tax increases?

The fact is that QE has caused inflation but not in the traditional manner that shows up in the Consumer Price Index (CPI). Instead, we've had what some call "asset price inflation" in stock and bond prices. The impact on bond prices is direct since most of the QE money went to suppress interest rates by buoying up bond prices. Bond sellers then bought stocks, inflating stock prices.

COVID Relief

Some believe that the checks issued by the Treasury are merely a refund of our taxes, that they're sending us our own money, but that's simply not true. COVID relief money is brand new money, although it's not "minted" in the ordinary way. It's created out of thin air. The Treasury issues debt that in the past has been purchased by investors, but most of these new issues are not being bought by investors; they're being "purchased" by the Fed. This is how money is "printed."

Much of the COVID relief money will be spent on goods and services, rather than stocks and bonds. This will move the CPI needle. Some observe that the needle is already moving. Are your meals getting more expensive?

Interest Rates

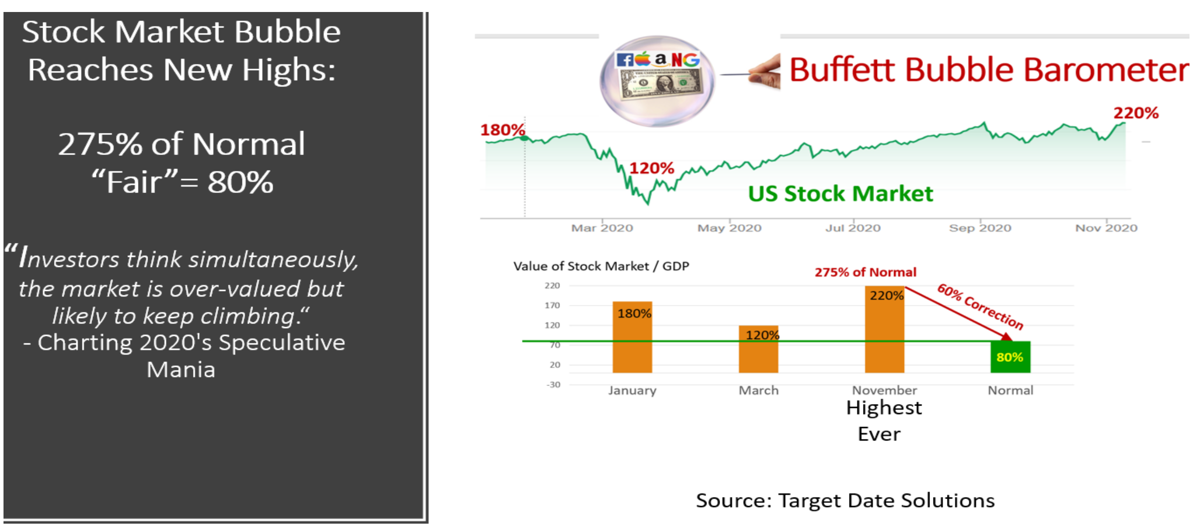
Low interest rates are good for borrowers and not lenders. Consequently, this is a horrible time for our 78 million baby boomers who are in or near retirement because they cannot invest safely and get a decent return on their investments. They're being driven to take more risk than they should at this critical time in their lives.

The Ugly

2008 Financial Crisis

QE has created a stock market bubble that some say is [the biggest ever](). Every measure of value, like Price/Earnings ratio, is at historic highs. As is usual when bubbles inflate, bullish investors insist "it's different this time" and that's true: interest rates have never been lower. I estimate that the reduction in interest rates has directly increased stock prices by 50% because future earnings are discounted at a low rate, but stock prices have increased by more than 300%. Plus, interest rates can't go much lower, so the bump is all already baked in – there's nothing left.

The following shows that Warren Buffett's bubble indicator is at 275% of normal, an all-time high.



QE has also exacerbated the great wealth divide in the US, leading to social unrest and a plea to move to socialism.

Source: Statista

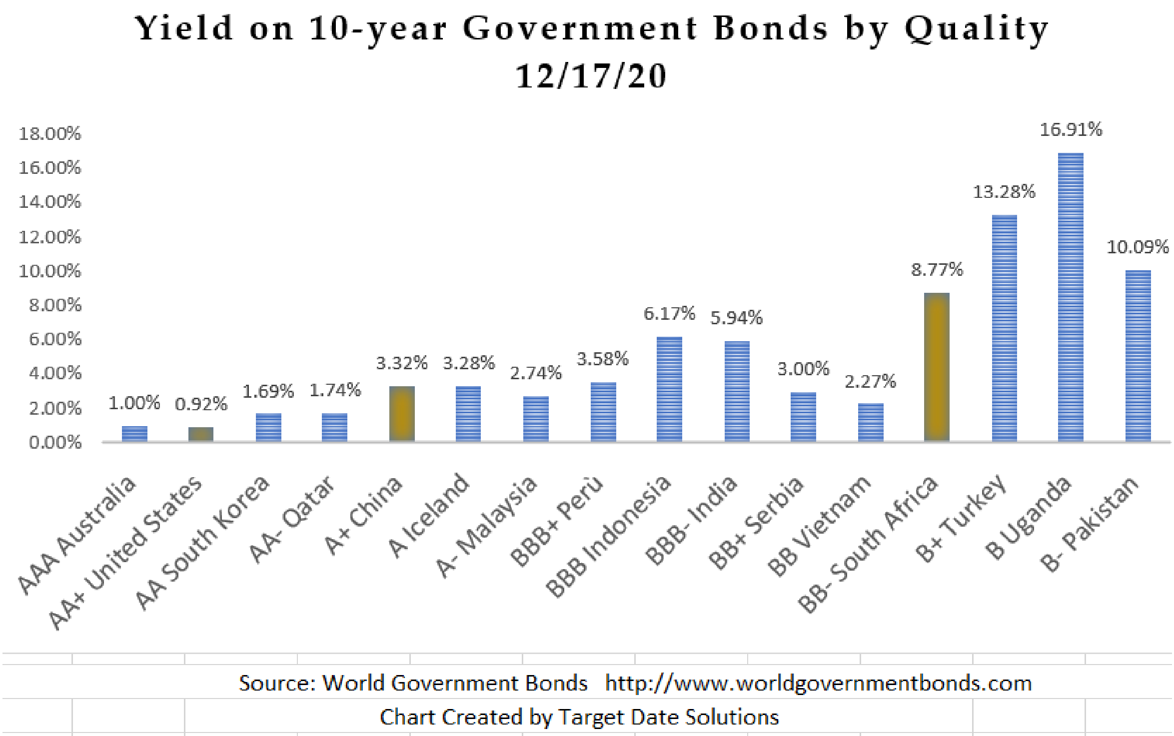
COVID Relief

No one knows how much money printing is too much, and what will happen when that limit is breached, but adding $6 trillion in relief to $4 trillion in QE is testing the limits of trust in fiat money. $10 trillion is about half of GDP, plus it is likely that the Biden administration will spend more than $5 trillion on infrastructure. The unfortunate reality is that the Fed is past the point where it could have stopped printing; it has to continue to print until something breaks. The common belief (hope?) is that this break will take a long time.

Fiat (paper) money only works if we all agree to honor it; otherwise, it's just pieces of paper. US currencies were debased in 1971, when they were taken off of the gold standard and replaced by "In God We Trust." Concerns about fiat money surfaced in 2020 when gold prices increased 25% and bitcoin skyrocketed 300%.

Interest Rates

If you're going to borrow a lot of money, you'll want to pay the lowest interest possible, so the Fed is creating money ZIRP: zero interest rate policy. The Fed is controlling the short end of the yield curve, letting investors price long-term Treasuries. At the time of this writing, 10-year US Treasuries yield 0.92% and are rated AA+ by S&P. By comparison, Chinese governments yield 3.32% and have an A+ rating, and if you'll move down to a BB- rating you can earn 8.77% in South African treasuries. Yields increase with lower quality, but you don't have to lower much.



The Fed might discover that they can't suppress interest rates forever. In the fourth quarter 2018 we got a hint of what happens when the Fed stops easing: stock markets plunge. Can the Fed ease forever?

When interest rates rise, as they should, the whole house of cards collapses.

- Stock prices plunge because future earnings are discounted at higher rates.
- Interest payments on the debt take away from other government programs, like welfare and military
- Inflation is likely because $trillions have already been printed and more is likely to be printed to monetize the debt

Conclusion

We all want to believe that our government is doing the right thing, but we fear that politicians are more interested in themselves and their re-election than the long-term consequences of their decisions. Money printing is a stopgap measure that will have serious long-term consequences, probably on our children and our children's children. This isn't over.

Please see **How to Minimize the Impact of Inflation, Recessions, and Stock Market Crashes** for some thoughts on protecting yourself.

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