Stocks Plunge 460 Points on Quantitative Easing (QE) Exit

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Global Research, October 16, 2014
CounterPunch

Region: USA
Theme: Global Economy

> "Financial markets are faced with uncertainty that isn't going away. The slowdown in Europe is probably in the early innings, the Fed hasn't begun to raise interest rates, and geopolitical crises seem to pop up by the day."
>
> Jeff Cox, Finance editor, CNBC

Six years of zero rates and trillions of dollars of asset purchases couldn't stop stocks from falling sharply on Wednesday. All three major indices moved deep into the red, with the Dow Jones leading the pack, dropping an eye-watering 460 points before rebounding nearly 300 points by the end of the session. Risk-free assets, particularly US Treasuries, rallied hard on the flight-to-safety move with the benchmark 10-year Treasury yield slipping to a Depression era 1.87 percent before climbing back above the 2 percent mark. US financials were the worst hit sector, taking it on the chin for 9 percent by mid-day, while Brent crude was soundly walloped, falling to a 47-month low on oversupply and deflation fears. Stock market gains for the year had nearly been wiped out before a miraculous about-face turned Armageddon into a so-so day with survivable losses. Even so, analysts have already started paring back their estimates for 4th quarter growth while traders stocked up on antacid for Thursday's opening bell.

The proximate cause of Wednesday's bloodbath was weaker than expected economic data from Europe–which is sliding towards its third recession in five years– droopy retail sales in the US, and a report from Department of Labor showing that wholesale prices for producers are edging closer towards deflation, the opposite of what the Fed is trying to achieve via its aggressive monetary policy.

But the real trigger for the selloff was not the dismal data, but the policies that have been in place since the Financial Crisis of 2008. While the Obama administration has steadily decreased demand by shaving the deficits which provide vital fiscal stimulus for the economy, (On Wednesday, the USG announced the budget deficit fell to $483 billion, the lowest since 2008) the Federal Reserve has been providing trillions of dollars of cheap money to the banks and brokerages. The result of this one-two combo has not only been the biggest transfer of wealth in human history, but also "a fundamental breakdown in the functioning of the global capitalist economy." As the International Monetary Fund (IMF) noted in a recent paper on the global recovery: "a pickup in investment has not yet materialized…reflecting concerns about low medium-term growth potential and subdued private consumption." Demand shortfalls in the advanced countries "could lead to sustained global economic weakness over a five-year period." (IMF report records global economic breakdown, Nick Beams, World Socialist Web Site)

Simply put: The Fed's policies have made investors richer, but they haven't created opportunities for recycling profits, which is a critical part of capitalism's so called virtuous circle. Anemic investment, means less hiring, less spending, weaker demand and slower growth, all of which are visible in today's sluggish, underperforming economy. Pumping money into financial assets (QE) can fatten the bank accounts of rich speculators, but it doesn't do jack for the economy. It just creates bubbles that burst in a flurry of panic selling. Here's more from Larry Elliot at the Guardian:

> "Six years after the global banking system had its near-death experience, interest rates are still at emergency levels. Even attaining the mediocre levels of activity expected by the IMF in the developed countries requires central banks to continue providing large amounts of stimulus. The hope has been that copious amounts of dirt-cheap money will find its way into productive uses, with private investment leading to stronger and better balanced growth.
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> It hasn't happened like that. Instead, as the IMF rightly pointed out, the money has not gone into economic risk-taking but into financial risk-taking. Animal spirits of entrepreneurs have remained weak but asset prices have been strong. Tighter controls on banks have been accompanied by the emergence of a powerful and largely unchecked shadow banking system. Investors have been piling into all sorts of dodgy-looking schemes, just as they did pre-2007. Recovery, such as it is, is once again reliant on rising debt levels. Central bankers know this but also know that jacking up interest rates would push their economies back into recession. They cross their fingers and hope for the best." (World leaders play war games as the next financial crisis looms, Larry Elliot, Guardian)

The policies implemented by the Obama administration and Fed have achieved precisely what they were designed to achieve; they've enriched the voracious plutocrats who run the system but left everyone else scraping by on less and less. An article in the Washington Post explains what's going on in greater detail. Here's a short excerpt from the piece titled "Why is the recovery so weak? It's the austerity, stupid":

"Welcome to Austerity U.S.A., where the deficit is back below 3 percent of GDP and growth is still disappointing—which aren't unrelated facts.

It started when the stimulus ran out. Then state and local governments had to balance their budgets amidst a still-weak economy. And finally, there was the debt ceiling deal with its staggered $2.1 trillion of cuts over the next decade. Add it all up, and there's been a big fiscal tightening the past few years, something like 4 percent of potential GDP. Indeed, as Paul Krugman points out, real government spending per capita has been falling faster now than any time since the Korean War demobilization. (chart)

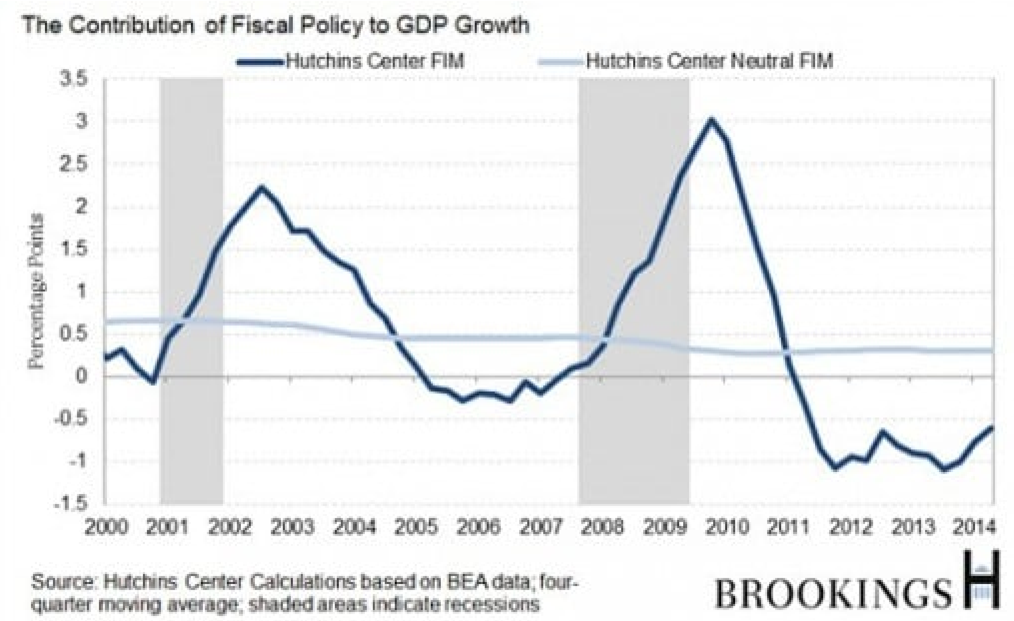

Image: Fiscal Impact Measure Source: Hutchins Center

> And, as you can see above, all this austerity has been hurting GDP growth since 2011. It shows the Hutchins Center's new "fiscal impact measure," which looks at how much total government tax-and-spending decisions have helped or harmed growth. The dark blue line is what policy has actually done, and the light blue one is what a neutral policy would have done. So, in other words, if the dark blue line is below the light blue one, like it has the last three years, then policy has subtracted from growth." (Why is the recovery so weak? It's the austerity, stupid. Washington Post)

By cutting the deficits, Obama reduced the blood flow to the real economy and weakened demand. That's what torpedoed the recovery. In contrast, stocks and bonds have done remarkably well, mainly because the Fed pumped $4 trillion into financial assets which was a taken as a greenlight by risk takers everywhere to load up on everything from overpriced equities to low-yield junk. Now, after more than three years without as much as a 10 percent correction, the momentum has shifted, volatility has returned, earnings are looking wobbly, and the fear is palpable. Stocks appear to be headed for a major repricing event. Here's how investment guru John Hussman sums it up in his Weekly Market Comment:

> "Our concerns at present mirror those that we expressed at the 2000 and 2007 peaks, as we again observe an overvalued, overbought, overbullish extreme that is now coupled with a clear deterioration in market internals, a widening of credit spreads, and a breakdown in our measures of trend uniformity…
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> …it has become urgent for investors to carefully examine all risk exposures. When extreme valuations on historically reliable measures, lopsided bullishness, and compressed risk premiums are joined by deteriorating market internals, widening credit spreads, and a breakdown in trend uniformity, it's advisable to make certain that the long position you have is the long position you want over the remainder of the market cycle. As conditions stand, we currently observe the ingredients of a market crash." (The Ingredients of a Market Crash, John P. Hussman, Ph.D., Hussman Funds)

Sounds ominous, doesn't it? And Hussman is not alone either. The bearish mood on Wall Street is gaining pace even among those who focus more on geopolitical issues than fundamentals, like the Bank for International Settlements' Guy Debelle who said in an interview on CNBC on Tuesday that he was concerned about the possibility of a "violent" market drop, particularly in bonds.

> "If I had told you that there were heightened tensions in the Middle East and Eastern Europe, uncertainty about the turning point in U.S. monetary policy, a succession of strong U.S. job numbers, uncertainty about the future direction of policy in Europe and Japan, as well as increased concern about the strength of the Chinese economy, you would not be expecting that to make for a benign time in financial markets,"

Guy Debelle of the BIS said. "But that is what we have seen for much of this year." (CNBC)

But stocks aren't cratering because of tensions in the Middle East or Eastern Europe. That's baloney. And they're not falling because of decelerating global growth, plunging oil prices or Ebola. They're falling because no one knows what the heck is going to happen when QE stops at the end of October. That's what has everyone in a lather.

Keep in mind, that 20 percent of the current market cap (more than $4 trillion) is stock buybacks, that is, corporations that have bought their own shares to juice prices. Do you really think that corporate bosses are going to play as fast and loose after the Fed stops its liquidity injections?

Not on your life. They're going to pull in their horns and see what happens next. And if things go sideways, (which they very well could) they're going to cash in and call it a day. That's going to drive down stock prices and send markets reeling.

Stocks have nearly tripled since March 2009 when the Fed started this "credit easing" fiasco. So if stocks rode higher on an ocean of Fed liquidity, then how low are they going to go when the spigot is turned off? There are some, like technical strategist Abigail Doolittle, who think the S and P 500 could suffer a major heart attack, dropping as much as 60 percent before equities touch down. Check it out from CNBC:

> "(Abigail) Doolittle, founder of Peak Theories Research, has made headlines lately suggesting a market correction worse than anyone thinks is ahead. The long-term possibility, she has said, is a 60 percent collapse for the S&P 500.
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> In early August, Doolittle was warning both of a looming "super spike" in the CBOE Volatility Index as well as a "death cross" in the 10-year Treasury note.
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> And so it's come to pass at least for the VIX, which has jumped 74 percent over the past three months and crossed the 20 threshold that historically has served as a dividing line between complacency and fear. That's its highest level in nearly two years. From Doolittle's perspective, the spike represents a bad-news/bad-news scenario … that the near-term selling action is likely to continue and even accelerate…
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> …she thinks "violent waves of selling action" could send the VIX all the way to 90—even beyond its peak during the financial crisis." (CNBC)

Now maybe Doolittle is just exaggerating or paranoid, but her conclusions do seem to square with CNN Money. Here's a clip from yesterday's article:

> "CNNMoney's Fear & Greed Index is a good indicator of market momentum. Today it hit zero. That's a huge red flag and showcases extreme fear in the stock market. The only other time the index ever touched that low point is in August 2011 — shortly after Standard & Poor's downgraded the U.S. debt.
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> Volatility — or what some are calling "market whiplash" — is clearly back in the market. The VIX, an index that measures volatility and is one of the factors that goes into the Fear & Greed Index — spiked again today. It's up a whopping 60% in the past week alone." (Extreme Fear in stock market, CNN Money)

So fear and volatility are back, but liquidity has suddenly gone missing. That sounds like a prescription for disaster to me. So what can we expect in the weeks to come?

Well, more of the same, at least that's how Pimco's former chief executive officer Mohamed El Erian sees it. Here's how he summed it up on Wednesday in a Bloomberg editorial:

> "Though unlikely to be as dramatic as today, market volatility can be expected to continue in the days and weeks to come as two forces compete: first, the forced deleveraging of certain investors, particularly overstretched hedge funds registering big October losses; second, central banks scrambling to say all sorts of reassuring things. All of this will serve to reinforce October's longstanding reputation as a threatening month for investors around the world." (October's Wild Ride Isn't Over Yet, Mohamed A. El-Erian, Bloomberg)

Did he say "forced deleveraging"?

Uh huh. So, after a 6 year bacchanal, the Fed is finally going to take away the punch bowl and force the revelers to pay down their debts, clean up their balance sheets, and take a few less risks. Is that it?

Yep. It sure looks like it. But, that could change in the blink of an eye, after all, the Fed has its friends to think of. Which means that Ms. Yellen could announce QE4 any day now.

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