Margin Debt Hits All-Time High: Prelude to a Crash?

By Mike Whitney
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Counterpunch

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The Fed's easy money policies have pushed margin debt on the New York Stock Exchange (NYSE) to record levels laying the groundwork for a severe correction or another violent market crash.

In December, margin debt rose by $21 billion to an all-time high of $445 billion.

Buying equities on margin, that is, with loads of borrowed cash, is a sign of excessive risk taking the likes of which invariably takes place whenever the Central Bank creates subsidies for speculation by keeping interest rates pegged below the rate of inflation or by pumping trillions of dollars into the bloated financial system through misguided liquidity programs like QE.

Investors have shrugged off dismal earnings reports, abnormally-high unemployment, flagging demand, droopy incomes, stagnant wages and swollen P/E ratios and loaded up on stocks confident that the Fed's infusions of liquidity will keep prices going higher. It's only a matter of time before they see the mistake they've made.

The chart below illustrates how zero rates and QE lead to excessive risk taking. The correlation between the stratospheric rise of margin debt and the Fed's destabilizing monetary policy is hard to avoid. This is what bubblemaking looks like in real time.

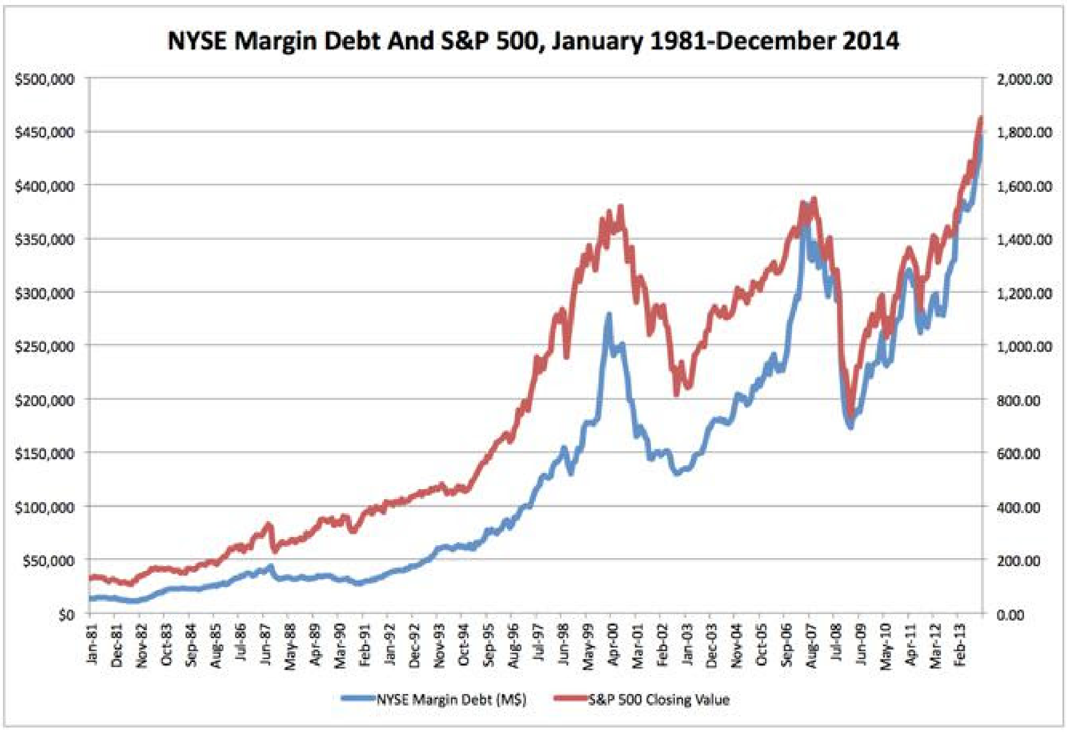


Chart: Seeking Alpha.

In the minutes of the FOMC's December meeting, FOMC officials acknowledge the froth they've created in financial assets which is why they've begun to scale back their asset purchases. The Fed hopes that by gradually winding down QE they'll be able to stage a soft landing rather than a full-blown crash. Here's an excerpt from the FOMC's minutes:

> "In their discussion of potential risks, several participants commented on the rise in forward price-to-earnings ratios for some smallcap stocks, the increased level of equity repurchases, or the rise in margin credit. One pointed to the increase in issuance of leveraged loans this year and the apparent decline in the average quality of such loans."

There you have it, the Fed sees the results of its work; the distortions in P/E ratios, the exuberant stock buybacks ("equity repurchases"), the deterioration in the quality of leveraged loans, and the steady rise in margin debt. They see it all, all the bubbles they've created with their gargantuan $3 trillion surge of liquidity. Now they have started to reverse the policy by reducing their asset purchase from $85 bil to $65 bil per month, the effects of which can already be seen in the Emerging Markets.

The bubble in Emerging Markets has burst sending foreign currencies plunging and triggering a sharp reversal in capital flows. The hot money that flooded the EMs,–(which lowered the cost of borrowing for businesses and consumers)–is entirely attributable to the Fed's policy. QE pushes down long-term interest rates forcing investors to search for higher yield in other markets. Thus, the cost of money drops in EMs creating a boom that abruptly ends when the policy changes (as it has).

Capital is fleeing EMs at an unprecedented pace precipitating a dramatic slowdown in economic activity, higher consumer prices and widespread public distress. The Fed is 100% responsible for the turmoil in emerging markets, a fact which even mainstream news outlets blandly admit. Here's an excerpt from an article in Bloomberg just this week:

> "Investors are pulling money from exchange-traded funds that track emerging markets at the fastest rate on record…More than $7 billion flowed from ETFs investing in developing-nation assets in January, the most since the securities were created, data compiled by Bloomberg show…
>
> Emerging economies have benefited from cheap money as three rounds of Fed bond buying pushed capital into their borders in search of higher returns…
>
> The Fed's asset purchases had helped fuel a credit boom in developing nations from Turkey to Brazil. Accumulated capital inflows to developing-country's debt markets since 2008 reached $1.1 trillion, or $470 billion more than their long-term trend, according to a study by the International Monetary Fund in October." ("Record Cash Leaves Emerging Market ETFs on Lira Drop", Bloomberg)

The Fed doesn't care if other countries are hurt by its policies. What the Fed worries about is how the taper is going to effect Wall Street. If the slightest reduction in asset purchases causes this much turbulence abroad, then what's it going to do to US stock and bond markets?

The answer, of course, is that stocks are going to fall…hard. It can't be avoided. And while the amount of margin debt is not a reliable tool for calling a top; it's safe to say that the recent spike in investor leverage has moved the arrow well into the red zone. Investors are going to cash out long before the Fed ends QE altogether, which means the selloff could persist for some time to come much like after the dot.com bubble popped and stocks drifted lower for a full year. Now check out this clip from Alhambra Investment Partners newsletter titled "The Year of Leverage":

> "For the year, total margin debt usage jumped by an almost incomprehensible $123 billion, while cash balances declined by $19 billion. That $142 billion leveraged bet on stocks far surpasses any twelve month period in history. The only times that were even close to as leveraged were the year leading up to June 2007 (-$89 billion) and the twelve months preceding February and March 2000 (-$77 billion). Both of those marked significant tops in the market." (Alhambra Investment Partners newsletter titled "The Year of Leverage")

Repeat: "The $142 billion leveraged bet on stocks far surpasses any twelve month period in history."

Investors are "all-in" because they think that the Fed has their back. They think that Bernanke (or Yellen) will not allow stocks to fall too far without intervening. (This is called the "Bernanke Put") So far, that's been a winning strategy, but that might be changing. The Fed's determination to taper suggests that it wants to withdraw its stimulus to avoid being blamed for the bursting bubble. ("Plausible deniability"?) That's what's driving the current policy. Here's more on margin debt from Wolf Richter at Testosterone Pit:

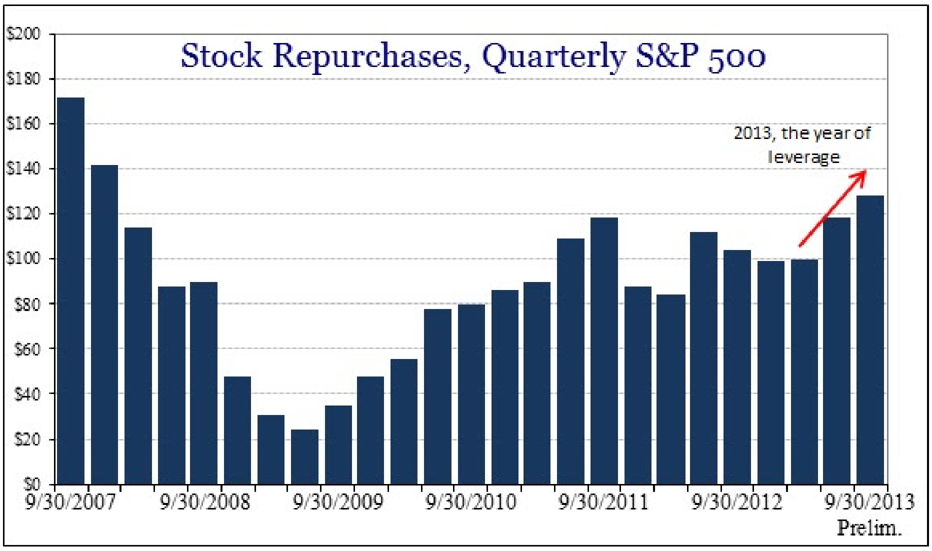
> "On the New York Stock Exchange, margin credit has been hitting new records for months. All three mega-crashes in my investing lifetime have been accompanied by record-setting peaks in margin debt. In September 1987, a month before the crash, margin credit peaked at 0.88% of GDP. In March 2000, when the crash began, margin credit peaked at 2.7% of GDP. In July 2007, three months before the downdraft started, margin credit peaked at 2.6% of GDP. Now, margin credit has already reached 2.5% of GDP." ("Plagued By Indigestion, Fed Issues Asset-Bubble Warning", Testosterone Pit)

Stock market crashes are always connected to massive leverage, loosey-goosey monetary policy and irrational exuberance ("excessive risk taking"), the toxic combo that presently rules the markets. The Federal Reserve is invariably the source of all bubblemaking and financial instability.

As we noted earlier, equity repurchases or stock buybacks are another sign of froth. Here's an excellent summary on the topic by Alhambra Investment Partners:

> "In the third quarter of 2013, share repurchases totaled $128.2 billion, the highest level since Q4 2007. For the twelve months ended in September 2013, aggregate share repurchases were an astounding $445.3 billion; the only twelve-month period greater than that total was the calendar year of 2007 and its $589 billion.
>
> The common argument advanced in favor of such share repurchases is that companies are using cash to recognize undervalued stocks, but that is total hogwash…

…corporate managers are no different than the reviled stereotypical retail investor. Both leverage themselves further and further as the market goes higher, not in recognizing undervalued stocks or companies but in full froth of chasing obscene values via rationalizations." (Alhambra Investment Partners newsletter titled "The Year of Leverage")



In other words, corporate managers are doing the same thing as your average margin investor. They are loading up on financial assets–not because they think they are a good value or because they expect higher earnings –but because Fed policy supports artificially-high prices. That's what's driving the bull market, the Fed's thumb on the scale. Remove the thumb, and you have a whole new ballgame (as we see in the EMs). There's also a bubble in high yield "junk" bonds which just had their second biggest year on record (Total issuance $324 billion) Investors are only too happy to dump their money into high-risk debt believing that companies never default or that the Fed will save the day again credit tightens and the dominoes start tumbling through the debt markets. According to Testosterone Pit:

"The cost of a high-yield bond on an absolute coupon basis is as low as it's ever been," explained Baratta, king of Blackstone's $53 billion in private equity assets. Even the riskiest companies are selling the riskiest bonds at low yields… Why would anyone buy this crap?" ("Bubble Trouble: Record Junk Bond Issuance, A Barrage Of IPOs, "Out Of Whack" Valuations, And Grim Earnings Growth", Testosterone Pit)

Why, indeed? Of course, the author is just being rhetorical, after all, he knows why people are piling into junk. It's because the Fed has kept a gun to their heads for 5 years, forcing them to grab higher yield wherever they can find it. That's how Bernanke's dogwhistle monetary policy works. By slashing rates to zero, the Fed coerces investors to speculate on any type of garbage that's available. That why junk "just had its second biggest year on record." You can thank Bernanke.

Housing is also in a bubble due to the Fed's zero rates, withheld inventory, government modification programs, and an unprecedented uptick in all-cash investors. Clearly, there's never been a market more manipulated than housing. It's a joke.

The surge of Wall Street liquidity has spilled over into housing distorting prices and reducing the number of firsttime homebuyers to an all-time low. The homeownership rate is actually falling even while prices climb higher, which is just one of many anomalies created by the

Fed's policy. (Who's ever heard of a housing boom, where the number of firsttime homebuyers is dropping?)

Also, the Central Bank has purchased more than $1 trillion in mortgage-backed securities (MBS) via QE, which begs the question: How can housing prices NOT be in a bubble?

As we noted earlier, the Fed understands the impact its policies have had. They know the markets are overheated and they're determined to do something about it. A recent article in Bloomberg explains the Fed's plan for winding down QE "without doing damage to the economy". Here's a short excerpt from the piece:

> "Janet Yellen probably will confront a test during her tenure as Federal Reserve chairman that both of her predecessors flunked: defusing asset bubbles without doing damage to the economy…
>
> Yellen is 'going to be trying to do something that no one has ever done,' said Stephen Cecchetti, former economic adviser for the Bank for International Settlements, the Basel, Switzerland-based central bank for monetary authorities. She needs 'to ensure that accommodative monetary policy doesn't create significant financial stability risks,' he said in an interview…
>
> The Fed's 'first, second and third lines of defense" for dealing with such imbalances is to rely on supervision, regulation and so-called macro-prudential policies, such as mortgage loan-to-value restrictions, Bernanke told the Brookings Institution in Washington on Jan. 16. ….Only as a last resort would it consider raising interest rates.' ("Yellen Faces Test Bernanke Failed: Ease Bubbles", Bloomberg)

You got that?

So the Fed is going into the "bubble-deflating" biz.

Check.

And uber-dove Yellen is going to put things right. She's going to eliminate the price distortions and gradually return the markets to normalcy.

Right, again.

She's going to wind down QE and start to reduce the Fed's $4 trillion balance sheet.

Oakie dokie.

And she's going to do all of this without raising interest rates or sending stocks into freefall?

Right. It's a pipedream. The first sign of trouble and old Yellen will be scuttling across the floor of the New York Stock Exchange with a punch bowl the size of Yankee Stadium.

You can bet on it.

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