The Federal Reserve's Insidious Role in the Stock Market Slide

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When the Dow Jones Industrial Average (DJIA) and S&P peaked in May 2015, investors were still confident that the Fed "had their back" and that any steep or prolonged downturn in stocks would be met with additional liquidity and a firm commitment to maintain zero rates as long as necessary. But now that the Fed has started its long-awaited rate-hike cycle, investors aren't sure what to expect.

This growing uncertainty coupled with flagging earnings reports have factored heavily in Wall Street's recent selloff. Unless the Fed is able to restore confidence by promising to take steps that support the markets, stocks are going to continue get hammered by economic data that's bound to deteriorate as 2016 drags on.

For the last few years, investors have relied on the so called "Bernanke Put" to prevent significant stock losses while the real economy continued to sputter and underperform. The moniker refers to the way the Fed adds liquidity to the markets during periods of stress to put a floor under stocks. Investors have been so confident in this safety-net system that they've dumped trillions of dollars into equities even though underlying fundamentals have remained weak and the economy has sputtered along at an anemic 2 percent per year. Investors believed the Central Bank could move stocks higher, and they were right.

The Dow Jones has more than doubled since it touched bottom on March 9, 2009 while the S&P soared to a new-high (2,130 points) on May 21, 2015, tripling its value at the fastest pace on record. These extraordinary gains are the direct result of the Fed's not-so-invisible hand in the financial markets. Betting on the Fed's ability to move markets higher has clearly been a winning strategy.

So why are stocks crashing now?

Because everything has changed. Up to now, "bad news has been good news and good news has been bad news". In other words, for the last few years, every time the economic data worsened and the media reported flagging retail sales, bulging business inventories, shrinking industrial production, anemic consumer credit, droopy GDP or even trouble in China–stocks would rally as investors assumed the Fed would intensify its easy money policies.

Conversely, when reports showed the economy was gradually gaining momentum, stocks would drop in anticipation of an early end to the zero rates and QE. This is how the Fed reversed traditional investor behavior and turned the market on its head. Stock prices no longer had anything to do with earnings potential or prospects for future growth; they were entirely determined by the availability of cheap money and infinite liquidity. In other words, the market system which, in essence, is a pricing mechanism that adjusts according to normal supply-demand dynamics–ceased to exist.

This topsy-turvy "good is bad, bad is good" system lasted for the better part of six years buoying stocks to new highs while bubbles emerged everywhere across the financial spectrum and while corporate bosses engaged in all manner of risky behavior like stock buybacks which presently exceed $4 trillion.

The Fed's commitment to begin a cycle of rate hikes (aka–"normalization") threatens to throw the financial markets into reverse which will slash stock prices to levels that reflect their true market value absent the Fed's support. The question is: How low will they go? No one really knows the answer, but given the sharp slide in corporate earnings, the stormy conditions in the emerging markets, the unprecedented decline in oil prices, and the buildup of deflationary pressures in the global economy; the bottom could be a long way off.

One thing is certain, the Fed will do everything in its power to prevent stocks from dropping to their March 2009-lows. Unfortunately, further meddling could be extremely risky which might explain why the Fed has not yet responded to the recent equities-plunge. As I see it, the greatest risks to the system fall into three main categories:

1) Asset bubbles

2) Danger to the US Dollar

3) Threat to US Treasuries market

It could be that the Fed is afraid that any additional easing will burst the bubble in stocks and bonds triggering a wave of defaults that could lead to another financial crisis. Or it could be that another round of QE (QE4?) could weaken the dollar at the precise moment that foreign rivals are threatening to topple the USD as the world's reserve currency which would greatly undermine Washington's global power and prestige.

Or it could be that more easing could constrict the flow of foreign capital into UST's. With petrodollar recycling at its lowest ebb in three decades and China already selling its cache of Treasuries to prop up its currency, a significant selloff of US debt could raise long-term interest rates sharply pushing the US economy deep into recession and forcing fiscal cutbacks that would leave the economy in the doldrums for years to come.

Whatever danger the Fed sees on the horizon, it's clear that the road to normalization is going to involve more than a few speed-bumps along the way. As for stocks; the extreme volatility and downward movement can be expected to intensify as the markets shake off seven years of rate-suppression and monetary "pump priming".

And while its still too early to know whether the recent turbulence signals the onset of another financial crisis, it certainly appears that Wall Street and the Fed are edging ever closer to their inevitable day of reckoning.

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