The Fed Fiddles While Stocks Burn and Crash

By Robert McHugh, Ph.D.
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The Dow Industrials plunged 306.95 points Thursday, closing at 12,159.21. Then the next day on Friday, they rallied at the open, only to plunge 319 points from their intraday high, closing down 59.91 to 12,099.30. ***NYSE volume*** was 122 percent of its 10 day average, with downside volume leading at 60 percent, with declining issues at 64 percent, with downside points at 63 percent. We either are at a multi-week bottom, or at the threshold of Hades. We took a small Traders Corner position on a bottom, but cannot rule out Hades. ***We are in an official stock market crash from October 11th, 2007, a 15 percent decline over three months. If prices do not immediately rally, it means stocks are hitting the sweet spot of the ongoing crash.***

I hate to bash Fed Chairman Ben Bernanke, but I'm going to for a few pages. Here's the deal. The current economic threat is screaming for an aggressive inflation solution. Inflation comes from the Fed. Forget about the inflation the Fed has caused over the past 90 years, and the doubling of the money supply to goose markets for the past eight. A lot of that was dead wrong, a theft of our children's future, coming at an unnecessary time. However, ***when economic crises hit, the government must inflate.*** Must. Aggressively, preemptively, not reactively, or else calamity will strike, deflation will result, a black hole sucking until depression hits. ***It is a lot easier to stop inflation during boom times than to reinflate an economy during a major bust.*** Japan taught us that. Ironically, this is supposed to be Bernanke's strong suit. He has written papers on the mistakes of the Fed that exacerbated the Great Depression of the 30's. The stock market is warning that we are approaching a bust.

Yet faced with an economic threat potentially larger than has ever hit mankind, Ben suddenly gets inflation-restraint religion. ***Who cares about inflation right now? It happened. It better continue to happen.*** First the threats: We know about housing and related financial institution real estate credit problems. Still coming are consumer loan problems, business working capital loan problems, derivative credit swap problems, entitlement problems, etc… Housing values have dropped 5 to 10 percent the past year. That means bank loan collateral has dropped, in many instances below loan value. There better be a reflation program put in place soon to get those collateral values higher. Otherwise, the deflationary black hole implodes. Bank examiners exacerbate a credit crunch, citing bankers for bad loans due to contracting collateral values due to bubblemania macroeconomic policy. This very act reduces demand for real estate, causing collateral values to sink further — spiraling deflation.

The Wilshire 5000 is essentially the entire U.S. stock market. Guess what? It has lost $2.6 trillion over the past 3 months, since October 2007 (which by the way was when the last Hindenburg Omen occurred). ***$2.6 trillion of wealth wiped out in three months, 25 percent of GDP, a 16 percent stock market collapse*** that looks to have much further to go. Bernanke would know this if his technical analysis staff would teach him how to read a Head & Shoulders pattern. But that isn't in the Princeton economics text. A stock market crash is a decline of 15 percent or more within several months. ***Well, we can now say we have seen a stock market crash over the past three months. More is coming***. Yet, Bernanke continues to speak of inflation risks, and continued growth, and all other manner of delusional hogwash. He behaves as if he is in academia, in front of a classroom, quoting the textbook, that interest rates must be lowered with restraint, that inflation must be slowed. Well, an all out economic collapse would slow inflation, that is for sure. ***New times bring new problems that require new solutions. Sometimes a Fed Chairman has to think outside the box, act decisively, act preemptively***, and not preoccupy himself with consensus building a Board of Fed Governors who behave in erudite abstract.

Bernanke is failing miserably at instilling confidence in Wall Street. ***When his moment arrived yesterday, Thursday, to announce convicting courageous reinflation action in the midst of a deflating economy, he took a pass, insisting Congress do something***, that the fiscal side of macroeconomic policy take the lead, provide the fix, insisting that would be the most efficacious course of action. Are you kidding Ben? You are the Fed Chairman, the most powerful financial person in the world! Wall Street couldn't believe their ears, and tanked in reaction. Why? Why has the stock market crashed over the past three months? Why are we seeing the bottom that every indicator on earth suggests should be here, even if it would be a temporary bottom, a ledge to grab hold of before the next fall, to catch a breath? Because Wall Street has lost confidence in the Fed Chairman. It is becoming increasingly evident that Bernanke is an amateur inside a crisis. The cat is out of the bag. He doesn't know what he is doing.

It is about confidence, Ben. You see, this whole world economy is built on smoke and mirrors, on confidence, on a belief that it works. Come on, money is created either from a printing press at the Fed or out of thin air through the bank lending function. Earnings come from inflation, productivity gains from illegal immigration. Taxes are not to fund government projects, to fund national defense, or to build infrastructure, taxes are an income redistribution scheme. Derivatives are a pyramid scheme, the economy is one big Ponzi scheme. Come on. These are the rules of the game. You can't ignore them, cannot change them in mid-stream, unannounced, because some textbook at Princeton suggests in chapter five that if you have inflation, you must not reduce interest rates.

It is about confidence. The Fed Chairman must act preemptively, must overreact if he has to, act decisively, make people believe he sees the problems before they do, instill a feeling of well being, that someone who knows what he is doing is at the helm, even if truth be know, he doesn't have a clue.

There was a layup opportunity Friday, January 18th. Nobody was guarding Bernanke. He could have taken the shot six times before a defender showed up. He didn't even shoot the ball. He took a time out, sat on the bench, and drank an energy drink to prepare him for the next shot. ***Stocks opened Friday nicely, the first advance in quite a while, what looked like a plunge-stopper start to the day. Up 1.5 percent at the open. Bush had***

announced his pathetic $150 billion fiscal plan (more on that later), and I kept waiting for step two, a surprise announcement that the Fed was on the job, was cutting interest rates half a point, maybe even 75 basis points. It was what the market needed to hear, that the reinflation medicine was being applied before the patient dies. Never happened. Nope. There is a scheduled open market operations meeting on the 29th, and that is when he will address interest rates. By the book. I'll bet Bernanke was the sort of professor who never curved a test, never gave extra credit, never considered class participation, never dropped the lowest quiz in the final grade. ***Wall Street's reaction? That 1.5 percent rally was reversed and we fell sharply the rest of the day.*** Confidence Ben. Learn what to say, learn what to do, or give up the job and let someone else with a clue do the heavy lifting.

The Bush plan: He suggested a fiscal stimulus package to the tune of 1.5 percent of GDP, about $150 billion. That is ridiculous. A stimulus package equal to 5 percent of the $2.6 trillion wealth wipeout from the past three months, and probably far less than the eventual wealth wipeout in total when all is said and done, including job losses, depreciated real estate, defaults, declining earnings, etc… ***Wall Street wasn't impressed.***

Are we expected to believe that if the government pays one mortgage payment later this year for every taxpayer, that is all we need to minimize the threats facing this economy? How about you? If you are struggling, are all your financial problems alleviated by one free month without a mortgage payment? Ludicrous. Risks have become threats. That is where we are. Time for creative solutions. Time to understand the Dollar must be sacrificed, either now, or later. Later will cost more.

Like in the early 90's, bank examiners must be told to let bankers lend at the very time when loans are going bad. That will kick start liquidity in the real estate industry, will boost collateral values, will increase bank earnings. The natural tendency is for bank regulators (and of course the big boy in that department is the Federal Reserve) to force a reduction in lending at the very time we need more lending. Lending is a key manufacturer of money and inflation. We need more, not less, and now.

The Fed needs to reduce interest rates dramatically and quickly, to encourage lending. ***Congress needs to pass regulations to put a stop to usurious 30 percent credit card interest rates,*** which are achieved through schemes that are scandalous, that wipe out consumer purchasing power. A massive, meaningful monetary handout needs to be sent to every household, enough to produce a serious reduction in debt, to help consumers clean up their balance sheets, which would quickly convert into significant increases in disposable income, spending, and a reinflation of the economy. This all takes courage, it all takes thinking outside the box. Confidence Ben. Replace the income tax with a national sales tax. Have money issued by the Treasury, have it backed by gold once the credit crisis is resolved, stabilizing the economy. We sit at the precipice of a financial meltdown if Bernanke, Bush and company do not get it right, and soon. Both Wall Street and Main Street have figured out the emperor is not wearing clothes. The power of suggestion is failing. Folks have smartened up. That dog don't hunt no more.

Robert McHugh Ph.D. is President and CEO of Main Line Investors, Inc., a registered investment advisor in the Commonwealth of Pennsylvania, and can be reached at www.technicalindicatorindex.com. The statements, opinions, buy and sell signals, and analyses presented in this newsletter are provided as a general information and education service only. Opinions, estimates, buy and sell signals, and probabilities expressed herein constitute the judgment of the author as of the date indicated and are subject to change without notice. The information contained in the newsletter is expressed in good faith, but its accuracy is not guaranteed. Nothing contained in this newsletter is intended to be, nor shall it be construed as, investment advice, nor is it to be relied upon in making any investment or other decision. Prior to making any investment decision, you are advised to consult with your broker, investment advisor or other appropriate tax or financial professional to determine the suitability of any investment. Neither Main Line Investors, Inc. nor Robert D. McHugh, Jr., Ph.D. Editor shall be responsible or have any liability for investment decisions based upon, or the results obtained from, the information provided.