Market Dynamics

Volume 10, Issue I15

April 15, 2011

Performance Management System

The Stock Market Runs On Money

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

"He who panics first—panics best"

Old Wall Street aphorism

A collection of recent newsletters is available on the web site.

Please visit my web site at
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I received several questions about my comment last week that a bubble in stocks was a type of inflation. A common sense definition of inflation is "too much money, chasing too few goods." So how does inflation occur in the stock market?

Inflation to many people has a very negative connotation because it refers to a rise in the cost of living. That type of inflation is bad because it increases the costs of items that most people buy and the purchasing power of their incomes seems to shrink. This is bad inflation.

A strong bull market in stocks is often referred to as a bubble. In a bubble almost all stocks rise to such high prices that it becomes unsustainable. The item that pushes stock prices higher and higher is money. Lots and lots of money. Where does this monetary fuel come from?

The banking system is the source of money creation. But how do the banks create money? In a fractional reserve banking system, such as found in the United States, the banking system creates money by making loans or buying investments. This expansion of money involves a multiplier of the amount of additional reserves held by banks. The amount of reserves held by the banking system is determined by the Federal Reserve Bank, an independent branch of the Federal Government.

A committee of the FRB determines the level of reserves available to the banking system. This control over bank reserves gives the FRB the power to regulate the nation's money supply. The FRB adds or takes away bank reserves by their open market purchases or sales of securities.

The buying of bonds or other securities results in a credit to the sellers' bank account and that credit adds to that bank's reserves. The receiving bank makes additional investments with those added reserves that after many such transactions results in a multiplied increase in the nation's money supply. Banks are profit seeking institutions and they can be expected to invest those additional reserves to earn a profit on the money. The FRB therefore controls and regulates the amount of money available for purchasing goods and services.

Some of this extra purchasing power will wind up in the hands of a stock buyer. This tends to push the prices of stocks higher. When large quantities of additional bank reserves are created by the FRB, it can result in a bubble in stock prices. A bubble in stock prices is an extreme form of a bull market—a mania.

The current situation has the potential to become a bubble because the FRB is buying extremely large quantities of government securities to help fund the nation's budget deficit. This inflation of stock prices is usually considered good inflation because the owners of stocks receive more profits from their stock investments.

But at some point the FRB stops the money creation mechanism and the stock market must adjust to the lack of additional buying power. The thing that makes stock market bubbles so dangerous is that the bull market stimulates the speculative buying of stocks on margin.

When the trend of stock prices turns down, these speculative trades must be reversed and that can develop into a full blown panic in the stock market.. Buying stocks on margin can increase profits on the way up but it also increases losses on the way down. History shows that stock prices go down much faster than they go up. This rapid rate of decline can quickly result in mounting losses for stock buyers, especially for margin buyers of stock. This is what causes the collapse of the stock market after a bubble is terminated. It's all about money and that is why the stock market runs on money..

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