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McGarrity: The coming decline in the stock - Log Cabin Democrat (Conway, AR) - May 17, 2017 - page 1

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Predicting future economic events is tough. Nobel laureate Milton Friedman knew this, so when he was asked to make a prediction about future interest rates, he said they will fluctuate, rather than pinning himself down on whether interest rates will increase or decrease. Despite knowing the difficulty of the task that I set out for myself, and not being as cagy as Friedman, I am going to make a prediction. I suspect the value of the stock
market will decline.

I believe that future stock prices will be determined by monetary policy. Here is a sketch of how it will play out. The Federal Reserve (Fed) manipulates the money supply to influence the economy. For example, it increases the money supply to lessen the severity of economic downturns. To do this, the Fed buys bonds from the public, leaving money in the hands of the people who sold bonds. The Fed hopes that with more money in their hands, people should increase their spending, which in turn should lead to faster economic growth.

To give you an idea of how much money the Fed has pumped into the economy, consider the value of the bonds that the Fed holds. Before the financial crisis of 2008, the Fed held bonds worth $900 billion. After a massive bond-buying spree that pumped a lot of money into the economy, the Fed is left holding bonds that are worth $4.5 trillion.

Despite the influx of money, the economy is not even growing at typical rates. Instead of fueling consumer spending, much of the money has gone into the stock market. Investors have used this extra money to bid up stock prices. Increases in the Dow Jones Industrial Average indicate that the stock market has performed very well in recent years.

Currently, the Fed is worried that the money that it pumped into the economy may lead to inflation or other economic problems. The Fed plans to start selling much of its bond portfolio to return to a more typical level of bond holdings. With each sale, a person gives money to the Fed in order to buy the security, taking money out of the economy in the process. With less money available, people will be unwilling to pay the current high prices for stocks. Those who want to sell stocks will find that they will have to accept lower prices.

Broadly speaking, when the Fed increases the money supply, one of three types of prices can increase: 1) stock prices, 2) housing prices, or 3) the general price level (the prices of goods and services), which is
referred to as inflation. As a general rule, the type of price that increased due to an influx of extra money into the system also drops when that money is removed. Since stock prices rose with the large increase in the money supply, I suspect that these prices will drop when Fed removes money from circulation.

I want to return to the folly of economists making predictions. While it is true that I successfully predicted the financial crisis of 2008 (the most important economic event of our generation), I made this prediction about 5 years too early — enough lead time that the prediction certainly was not actionable advice. Given my prognostication experience, I need to remain humble with my predictions. While I am confident that the stock
market will see a decline in prices due to monetary policy, I have no idea of the size, timing, or duration of this correction (nor, I would argue, does anyone else). This column will be more useful in helping you understand the stock market decline when you see it, and a lot less useful in helping you make money from the coming drop in stock prices.

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