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Controlled Chaos

The intention of the monetary and fiscal bailout plans was to bring liquidity and function to financial markets, while simultaneously providing pecuniary assistance to businesses and individuals during the economic slowdown. The Federal Reserve's actions and liquidity facilities have certainly improved financial markets recently, but they come with significant costs. One victim is the financial market itself which may never function properly again. Jim Grant is right when he said, "The Fed acts as both Fireman and Arsonist".

Financial markets play an important role in the economic growth of a country. They act as intermediary between lenders and borrows providing for the efficient deployment of capital; a critical role for businesses, employment and economic expansion. It's supposed to be a place where supply and demand factors combine to determine equilibrium prices. Unfortunately, trouble arises when government institutions like the Federal Reserve manipulate and distort this process.

Basic investment used to be about assessing risk to see if the corresponding expected return is acceptable. An investor was compensated for taking more risk. Most investors know the term, "more risk, more reward".

Conservative investors stay near the top of the capital stack (hierarchy) – near AAA government bonds or near the highest quality investment grade bonds. Their relative safety and capital preservation characteristics naturally yield a low(er) return. Those willing to accept junkier credit risk usually receive a higher rate of return. Stockholders, who are owners of the company, hold the riskiest position. Equities are the lowest part of the capital structure, because a company can go bankrupt and equity holders get paid back last, if at all.

The recent bailout(s) has turned this hierarchy on its head. Those who were willing to accept higher market risk have already been rewarded <u>for many years</u> through higher returns. The bailout rewards the risk-seekers a second time and socializes their loses across all conservative investors. Loses should be borne by the risk-taker and not be distributed or financed by the taxpayer. After all, it was the risk takers decision to assume the risk in the first place.

A whole series of further questions arise. Should the government give free money and cheap loans to companies who ran out of money due to poor management? What if corporate cash flow was used to buy back shares, or used to reward executives instead of preparing for a "rainy day fund?"

Would it be better to allow bankruptcy that wipes out equity and debt holders? After all, companies often continue to function with employees keeping their jobs, and with new management operating from a stronger position. Allowing bankruptcies would help re-focus investors on the true meaning of risk and encourage stronger corporate management in the future.

In addition, taxpayers are not getting much in return for its money, particularly with grants that opens the flood gates for fraud. Government should negotiate with the fierceness of a private investor. And, steering the majority of bailout money to Wall Street rather than Main Street is an expansion of bad Fed policies that have widened wealth inequality and promoted backward incentive policies which reward speculators and debtors, while punishing savers, pensions and those on a fixed income.

This crisis is particularly unusual because the coronavirus has introduced unquantifiable uncertainties. The ad-hoc, randomly announced, and discretionary governmental responses add to the uncertainties. Investors and policy officials are conflating uncertainty with risk this in itself could have considerable unintended consequences in the long run.

The great economist Joseph Schumpeter coined the phrase "creative destruction" and is known for his work on circular flow in economic cycles. He believed the basis for capitalism was the "old" being replaced by the "new". New beneficial technologies would come along improving productivity that eventually wipes out the profits of the "old". Necessity is a great motivation for innovation, so bad and insolvent companies *should* go under. When they do, labor and capital are redirected to more productive sources and away from "zombie companies." Entrepreneurial innovation then operates at its fullest, making higher standards of living possible.

The extreme moral hazard that the intervention has created makes assessing market risk, not only impossible, but sadly unnecessary. Today's investing paradigm has morphed into merely front running the Fed. The Fed "put" is alive, evident, and in motion. Investors now get risk-free returns for risky assets. Do all securities now have an implicit quasi-government guarantee? Is every security now basically rated AAA?

In a nutshell, markets are broken. The rules of investing are less known today than the rules of a casino. This will have enduring and negative consequences for everyone. Governments and central banks have missed a great opportunity for a reset.