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Why the Federal Reserve is Pushing Stocks

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Following past recessions, the Federal Reserve stimulated private sector borrowing by lowering interest rates and bank reserve requirements. This in turn encouraged increased economic activity by way of the “multiplier effect” – each dollar borrowed magnified the speed of the recovery, as each economic level benefited from the initial dollar of borrowing. But this economy has been different, as credit expansion has been abnormally slow. Instead of expanding bank borrowing, companies have reduced it by refinancing into longer-term bonds. The results are better balance sheets and higher levels of working capital – the seeds of improving capital investment -- which should ultimately lead to increased hiring.

The Fed has two primary objectives: to manage a monetary policy promoting full employment, and to manage inflationary expectations. By adjusting the cost of borrowing money and influencing bank lending, the Fed heats up or cools down the domestic economy. In past economic cycles, Fed policy has impacted the value of the dollar, increased unemployment by encouraging firms to move operations offshore (Volker), promoted home ownership financing (Greenspan), and now under Ben Bernanke – encouraged investors to buy stocks.

The simplest illustration is appreciating how Bernanke’s current zero interest policy is strengthening the balance sheets of public companies. With borrowing costs so low, these companies have a reduced reliance on cumbersome bank credit facilities because of restructuring to low interest rate corporate bonds. Companies benefit with reduced interest costs and a pushing these obligations well into the future. Stronger balance sheets provide public companies with more working capital to grow their businesses, invest in new capital equipment, hire employees, and pay higher dividends.

Dividend yields of large U.S. companies (S&P 500) are higher than 10-year government bonds (2.1% vs. 1.5%). A number of stocks in this index are paying yields above 3.5%. Investors see the attractive comparative dividend, but remain skeptical.

The Fed’s policy in promoting stock ownership is slow going, but it just might do the trick. A prolonged period of zero policy rates, along with the specter of rising interest-rate based bond value declines, is attracting money from bonds and cash. The Fed has clearly moved towards unconventional means to stimulate the domestic economy. Historically, bank lending has been the mechanism driving economic cycles. But with today’s weak credit expansion, the approach by the Fed in pushing stock ownership is novel and experimental. A risk is this policy brings on significantly higher inflation in the future as the rate of money supply growth and credit exceed U.S. and global GDP growth. However, it appears this is a risk the Fed is willing to take.

