# MARGIN DEBT, FED POLICY, AND RECENT AMERICAN STOCK PRICE TRENDS

**© Leo Haviland, 646-295-8385** March 18, 2013

"Beautiful credit! The foundation of modern society. Who shall say that this is not the golden age of mutual trust, of unlimited reliance upon human promises?" "The Gilded Age", by Mark Twain and Charles Dudley Warner (Chapter 26; published 1873)

## CONCLUSION

Many observers point to booming corporate profits as a key reason for the splendid rally in United States stocks since March 2009's dreary depth. The Federal Reserve's generous highly accommodative monetary policy since late 2008, highlighted by sustained rock-bottom interest rates (yield repression) and several rounds of spectacular money printing, nevertheless coincides with this climb in corporate profits and the marvelous S+P 500 advance.

**Many marketplace clairvoyants, including quite a few regulators, worry little about borrowing levels (and leverage) in the context of the wonderful ascent in American stocks. However, they should.**

**Soothsayers should examine New York Stock Exchange (NYSE Euronext) margin debt levels alongside the timing of Federal Reserve policy innovation and very important trend change points in the S+P 500. In recent years, pinnacles of NYSE margin debt have occurred close in time to those in US stocks; valleys in that debt roughly have coincided with S+P 500 troughs. Glancing back to the 2000 stock top and the depths of 2002/2003 shows a similar pattern.** For the recent bull trend in American since first quarter 2009, underscore the Fed's policy actions (and a couple of European Central Bank ones) alongside these turning points in margin debt and American stocks. The most recent statistics (for January 2013) and the probable current margin debt levels are very elevated from the historical perspective. They consequently should concern marketplace watchers, even if many sentinels retain faith that there remains scope for even more margin debt and that lax Fed policies and booming corporate profits will persist.

## THE FAITHFUL FED'S MAGIC TOUCH IN ACTION

"It was astonishing how many New England clergymen, in the time of the petroleum excitement, took chances on oil. The Wall Street brokers are said to do a good deal of small business for country clergymen, who are moved no doubt with the laudable desire of purifying the New York stock board." "The Gilded Age", by Mark Twain and Charles Dudley Warner (Chapter 50)

****

Debt (leverage) of course exists outside of the NYSE context and beyond the equity sector. And the Federal Reserve wizards of course have not performed alone during the worldwide international economic crisis and the current recovery. Other central bankers have assisted it. Gigantic deficit spending in America and elsewhere should not be forgotten. Levels and trends for US interest rates (not just Federal Funds and US Treasuries) and the US dollar (and other currencies) as well as numerous other variables intertwine with leverage (and debt levels). Is there a New Era for US stocks?

Some US stock marketplace gurus shout that strong "investment" factors- whether fine earnings, worldwide economic recovery, excellent long run prospects, low interest rates, a relatively feeble dollar, and so on- justify current S+P 500 levels, and arguably eventually even higher ones. Perhaps US equities may keep rising. After all, nominal GDP probably will increase over the long run, right? And recent nominal GDP (2012 calendar year at about $15.7 trillion, 4Q12 about $15.9tr) is above that in 2007/08 ($14.0tr for calendar 2007, $14.3tr in calendar 2008, and $14.4tr at its height in 2Q08). The Fed remains resolute in its pilgrimage to create sufficient inflation. And stock prices are quoted in nominal terms.

The most recent margin debt level (January 2013) is below that existing in July 2007 peak, and the economy (nominal GDP is higher now). So some may argue there is currently more room to borrow. But margin debt likely already has grown as equities have climbed over the past several weeks. In any event, the past association of margin debt boosts and declines with US stock marketplace rallies and bear moves, and the probable current high level, indicates that one should pay attention to the convergence of debt levels with stock marketplace patterns.

****

Anyway, survey NYSE margin debt, Fed actions, and S+P 500 trends together. As in the joyous rally to the highs in US equities in 2007-08, judging from the NYSE margin debt statistics, a fair amount of leverage probably has encouraged the bull move in US equities since the March 2009 lows. That includes the recent S+P 500 spike since June 2012. The friendly Fed and its devoted allies probably deserve a hefty share, though not all, of the credit for these margin borrowing leaps since the equity abyss of first quarter 2009. And especially if US Treasury yields are low, why not search enthusiastically for yield (return) in US stocks?

****

The New York Stock Exchange (NYSE Euronext) has published margin debt ("Securities market credit") statistics for decades. NYSE member organizations are required to report monthly their aggregate debits (amount borrowed by customers to buy securities) in margin accounts, as well as aggregate free credits (cash balances) in cash and margin accounts.

In the following table, end month margin debt is in billions of dollars. The NYSE debt includes sums in addition to borrowing of the general stock margin account (note bond accounts). Although its website does not break down the total margin debt by category, probably most of it is associated with equities. Although the margin debt tables refer to NYSE member organizations and not to American stocks, probably most of the debt ties to American equities. January 2012 is most recent. In the table, S+P 500 highs and lows are for the given day (and rounded), with the Federal Funds level the monthly average. "OMT" stands for the European Central Bank's Outright Monetary Transactions policy, "LTRO" for its long-term refinancing operation via low-interest loans. Within the table, the ******** separates three extended time periods during which margin debt climbed substantially. So based upon these three relatively very elevated margin debt levels, compare the times of 2013, 2007, and 2000.

When scanning the table, in addition to other magical Fed actions such as money printing (quantitative easing), keep in mind the ground floor Federal Funds level since end 2008. This interest rate policy underpins the S+P 500's rally since March 2009 in all its stages.

****

| **NYSE MARGIN DEBT**<br>**High** | <br>**Low** | **S+P 500**<br>**High** | <br>**Low** | **KEY CENTRAL BANK POLICY ACTION** |
|---|---|---|---|---|
| **$364.1 billion (as of Jan 2013) (probably higher now; compare with 2007 plateau)** | | 1564 (3/15/13; high to date) | | |
| | | 9/14/12 at 1475 | | |
| | 277.7 (July 2012) | | 11/16/12 at 1343<br>6/4/12 at 1267 | Federal Reserve money printing: 12/12/12 QE4 (+ policy guidance) and 9/13/12 QE3<br><br>ECB President: “whatever it takes” speech to preserve Euro 7/26/12; ECB reveals OMT 8/2+ 9/6/12 |

Central bank easing efforts, particularly since summer 2012, are remarkable. Wasn’t there a genuine recovery for over three years as of summer/late 2012? Audiences particularly should study Federal Reserve Board sermons about its mandate, unemployment, and inflation from the vantage point of the American stock marketplace level and trend. Since the Fed actions and incantations around QE3 did not generate a S+P 500 rally from the 1475 level prevailing around then, it introduced QE4 (and its related policy statements) to help make sure stocks advanced. Note the 31.1pc rise in margin debt from July 2012 to January 2013.

| | | | | |
|---|---|---|---|---|
| 298.5 (April 2012) | | 4/2/12 at 1422 | | |
| | 262.1 (Sept 2011) | | 10/4/11 at 1075 | Operation Twist announced 9/21/11; European Central Bank heralds LTRO 12/8/11 |
| 320.7 (May 2011) | | 5/2/11 at 1371 | | QE2 ceases June 2011 |
| | 231.1 (June 2010)<br>235.7 (August 2010) | | Initial low 7/1/10 at 1011, final low 8/27/10 at 1040 | QE2 unveiled August and Nov 2010 |
| $261.8bb (April 2010) | | 4/26/10 at 1220 | | QE1 ends March 2010 |
| | 173.3bb (Feb 2009) | | 3/6/09 at 667 | QE1 money printing announced Nov 2008 + |

March 2009

Federal Funds crash under .25pc Dec08; stay there up to the present

[The sustained Fed easing policy surely has done no harm to corporate profits. Moreover, arguably the Fed’s policy also has tended to encourage net buybacks of US equities. See the Federal Reserve Board Z.1, “Flow of Funds” (Table F.213, 3/7/13). In calendar 2011, there were net buybacks of almost $219 billion in stock; in 2012, the total net share repurchases reached $208bb. Compare 2010’s net buybacks of only around eight billion dollars. Contrast these net buybacks of 2011 and 2012 (and probably in 2013 to date) with the net issues (sales) of about $316bb in 2009 and $265bb in 2008.]

********

| **NYSE MARGIN DEBT** High | **NYSE MARGIN DEBT** Low | **S+P 500** High | **S+P 500** Low | **KEY CENTRAL BANK POLICY ACTION** |
|---|---|---|---|---|
| $334.9bb final high (February 2008); after dip to 329.5 in Sept 2007, rose to 345.4 in Oct 2007 | | 5/19/08 at 1440 (final top) | | Fed Funds fall to 1.98pc (May 2008; 2.00pc through August 2008) |
| **$381.4bb peak July 2007** | | 10/11/07 at 1576 (initial top 1556 on 7/16/07) | | Fed Funds peak 5.25pc (July 2006 to July07) |
| | Notable advance from 2006’s 222.8 (Feb)/ 225.8 (June)/226.5 (Aug); Yet low was 134.0 (February 2003) and 130.2 (Sept 2002)/130.6 (Oct 2002) | | 10/10/02 at 769 and 3/12/03 at 789 (and see a later take-off point in the S+P 500 from 6/14/06’s 1219 and 7/18/06’s 1225) | Fed Funds lows 1.75pc (Oct 2002), 1.25pc (March 2003), .98pc (Dec 03) |
| | | ******** | | |
| **$278.5bb (March 2000)** | | 3/24/00 at 1553 | | Fed Funds peak 6.54pc (July 2000) |
| | Increase from lows at 151.5bb (Feb 1999; compare July 1998 high 154.4) and 59.8 (Feb 1995)/59.9 (May 1994) | | S+P 500 rally from lows at 436 on 4/4/94 and 443 on 12/9/94; recall 7/20/98 high at 1191 followed by the slump to 10/8/98’s 923; the S+P 500 climbed from 1Q99 interim low levels around 1200- 1/13/99’s 1206, 2/10/99’s 1212, and 3/3/99’s 1216 | Fed Funds rate fell from 6.05pc (April 1995) to 4.63pc (January 1999) |
| | | **** | | |

Federal Funds rate levels and trends do not automatically determine patterns in stock levels and NYSE margin debt. However, they may influence them. Yet the extent of the Fed Funds role not only is a matter of opinion, but also marketplace history is not destiny.

All else equal, sustained "high" levels of Federal Funds (even if only eventually) can weigh on (help to reduce) elevated levels in the S+P 500 (and other benchmarks such as the Dow Jones Industrial Average, and "related" overseas stock domains) as well as high totals of NYSE (and other) margin debt. Similarly, sustained "low" Federal Funds ultimately can spark and sustain significant rallies in American stocks and the ballooning of margin debt.

The extremely low level of the Federal Funds rate since December 2008 arguably has encouraged the sustained overall rise in margin debt and US stock prices since early 2009. In a similar fashion, the low Federal Funds rate from late 2002 through December 2003 and which persisted for some time thereafter probably aided the interrelated margin debt increase and equity rally. In addition, the initial tumble in the Fed Funds rate from July 2007 to May 2008's two percent assisted the boost in margin debt (from its earlier dip to December 2007's $322.8bb) up to its February 2008 final peak total and the related tops in the S+P 500 in October 2007 (major top) and May 2008 (final top).

Likewise note the big rise in margin debt that culminated in March 2000 alongside the S+P 500 summit. The modest Fed easing from April 1995 to January 1999 (use the declining Fed Funds level as a yardstick) helped to send the S+P 500 skyward to its March 2000 peak alongside the comparable summit in margin debt.

Yet what a high or low Federal Funds rate (or a significant or a sufficient move) in it depends on the perspective of the viewer. Note the higher Federal Funds levels in early 1999 relative to those in October/March 2003 and December 2008. Also note that the Fed Funds rate mounted up to the 2000 stock peaks. However, it initially rose only slowly, not exceeding five percent until August 2009's 5.07pc.

An apparently low Federal Funds level or significant drops in it do not always translate into expansion of margin debt or bull equity moves. From August 2008, further declines in Federal Funds under two percent- a rather low rate in the scale of yields- paralleled substantial drops in US stocks and margin debt. So in some circumstances, might an extremely low Federal Funds rate, at some point not inevitably lead to eternal (further) rises in American stocks and margin debt?

## **CONFIDENCE GAMES**

The Fed preaches that it has an exit strategy for its mesmerizing extravagant easing policy. To what extent should Wall Street and Main Street believe that implementation of the supposedly superb plan will be rather painless?

****

US after-tax corporate profits (without inventory valuation and capital consumption adjustments), from 1946-2011 averaged about 6.2 percent of nominal GDP (during 2004-2011, they averaged just over nine percent).

In recent periods, American after-tax corporate profits have accelerated to new peaks. In 3Q12, they edged over 11.0pc of 3Q12 nominal GDP (seasonally adjusted, annual rate). Some estimate US 4Q12 earnings increased around 6.5pc versus the same prior year quarter. That would make 4Q12's corporate profits about $1667.9 billion. With 4Q12 nominal GDP about $15.9 trillion, 4Q12 profits would be roughly 10.5pc of GDP. For full year 2012, averaging the seasonally adjusted annual rates for the four quarters (with the 4Q12 level estimate) gives 2012 corporate profits, of $1686.4bb. Versus calendar year 2012 nominal GDP of about $15.7tr, corporate profits are almost 10.75pc of GDP. This 2012 percentage represents a new record, breaking 2006's 10.1pc, which followed 2005's 9.7pc.The 2005/06 years had been the highest since many decades before, with long ago 1950's 8.6pc the nearest notable previous comparably high elevation.

Times change, so maybe corporate profits will remain lofty in nominal terms, especially if assisted by Fed and other central bank money printing and low rates. But suppose they don't.

****

Peaks and troughs in the Conference Board's Consumer Confidence measure often have roughly coincided with significant highs and lows in the S+P 500 (data back to 1967). For example, the February 2009 all-time low of 25.3 occurred around the time of the S+P 500's major bottom in early March 2009. In October 2011 (recall the stock marketplace low that month), it was 40.9. Remember March 2003's bottom at 61.4 alongside the S+P 500's final valley that month.

The Fed and other central banks have long walked on the easing road. Deficit spending by US, Japan, and much of Europe has been huge. Stocks are high, margin debt is lofty, and consumer balance sheets in nominal terms (helped by higher equities) look considerably better in nominal terms than during the depths of the international crisis.

Do the 2013 highs in the S+P 500 represent a new golden age for one and all, or at least for most Americans? Aren't US consumers, who represent about 70 percent of US GDP, generally very happy? Apparently not, judging from consumer confidence levels now in comparison to the peaks of 2000 and 2007.

The S+P 500 now hovers around its 2000 and 2007 pinnacles. The January 2000 consumer confidence peak was 144.7 (Dow Jones Industrial Average high at about 11,910 preceded the S+P 500's 3/24/00 one at 1553). In June 2007, the benchmark confidence measure attained its 111.9 summit. This was at the dawn of the global financial crisis (consumer confidence collapsed from 90.6 in December 2007). But in February 2013, consumer confidence was merely 69.6. The high since February 2009 is 73.1 in October 2012, about half of the 2000 peak. Maybe it has risen over the past month or so. However, confidence probably currently still stands far beneath the 2000 and 2007 heights.

****