

Deprcon warning: Asset market "schizophrenia" (5/2/2021)

- Asset markets are in a "schizophrenic" state, at risk of either a collapse or a melt-up.
- Risk of a collapse is driven by extreme valuations and waning central bank support.
- Risk of a melt-up is driven by the possibility of continued investor euphoria and "leaks" of excess reserves and the TGA.

Stock and credit markets in the U.S. are currently at extreme valuations. The Schiller PE (price-to-earnings) ratio currently stands at around 35, the highest since the Tech Bubble and past the peak (around 30) of the 'Black Tuesday' of 1929. Credit markets in an intrinsic bubble with, for example, the yields in "junk bond" markets at historic lows.

At the same time the Fed is sending mixed messages with some Fed presidents flirting with the idea of tightening via a Fed "taper" or waning monetary support. These contribute to the down-side or outright collapse risks.

A contrary (melt-up) force is created by increasing involvement of retail trading through the likes of RobinHood and WallStreetBets, and the possible runoff of central bank excess reserves held at Primary Dealer banks and the 'checking account' of the Treasury at the Fed.

Excess reserves basically "sit" on the balance sheet of banks, while the central bank pays extra reserves for them. However, they can "leak" or even "gush" out of the balance sheets of banks as credit, if banks see that they can earn higher interest on them abroad. When the U.S. economy improves, however artificially, banks may start to off-load these reserves. We can easily imagine a scenario where this money (credit) would be used to increase speculation in the financial markets. There's also over 1.6 trillion dollars in the Treasury's General Account (TGA) at the Fed, which can be channeled to, e.g., stimulus quickly.

These possible developments thus contribute to the "melt-up" risk of asset markets.

We clearly are in the midst of an asset market mania which, in the short-run, may either melt-up or crash. Thus, extreme caution in all investment activities is warranted.