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Financial Markets
Red Hot: But Don’t Let The Smoke Out

This article is not about sensationalized reports about wildfires or hot weather.

It is about cars and speculative financial markets, both of which can be exciting as well as at times dangerous.

When tinkering with old cars it is best not to go near the electrical wires as there is weirdness there. Black ones are cool most of the time. But because they can get hot, the red ones are unquestionably taboo, which is why they are red.

But if you must fiddle with them, be careful not to let the smoke out. That happens and the engine will not run. Sometimes the smoke will come out all on its own – same thing – the car won’t run.

A good thing about new cars is that you can’t see the wires. What you can’t see, shouldn’t worry you. So, new cars run forever.

Beyond wires, a Tesla has the addition threat of more than a thousand pounds of battery. And lithium smoke is uniquely hazardous.

New participants to the financial markets are taught that prices always go up and to never even know there are wires, let alone ever thinking about tinkering with them. Wizards who are custodians of the ancient financial theories boast that nothing can go wrong. Recessions can be prevented by manipulating the secret wires. People from veteran bond investors to novice day traders need not worry about risk. With no visible threats, and the Fed controlling things bull markets run forever.

With always outstanding corporate management and the genius of central bankers, adversity is limited to minor setbacks.

In December 2007, Harvard’s Greg Mankiw boasted that nothing could go wrong. Because the Fed had a “dream team” of economists.

In 1929, John Moody boasted that nothing could go wrong. Because the Fed was “new and scientific”.

You get the picture.

Considering how intense the speculation has become, when it comes out it won’t be just puff of white smoke equivalent to signaling the election of a pope.

Fortunately for market veterans, there are technical measures that are warning that the financial wires are getting very hot. The hottest since the popular manias that climaxed in 2007 and 2000. Bubbles, in any century, are dangerous and failure has been signaled by changes in the credit markets.

Although unfamiliar with the smoke theory, quite likely the Fed is doing everything it can to keep the smoke from getting out.

To keep the party going!

For how long?

Ironically, there are real wires that central bankers have absolutely no control over. And these are in the credit markets, commodities and the weirdest of weird—the velocity of money.

What "velocity" does is add to credit creation on the way up and to exaggerate credit contraction on the way down.

Effectively pointing out that Fed credit is not needed during a boom and is cancelled out during the contractions.

***"The Federal Reserve policy of cheapening credit through the purchase of government bonds has been unable to make a dent in the conservatism of borrower or bank lender, in short, every anti-deflationary effort has yet to provide positive results. The depression is sucking more and more bonds into its vortex*."**

Barron's, July 1932.

Most of the great stock bubbles have clocked a regular timing pattern. This is the year that a great bull market could become hot enough to complete. Since the advent of modern financial markets by 1700, most of the great stock bubbles have concluded a decade after the climax of a great speculation in commodities.

This brief history would not be written if there weren't signs of excessive speculation (✓) about a decade after the equivalent in commodities (✓). The last big global high in commodities was in 2011.

That's when Copper prices were so high that druggies were stealing wires from electrical utilities. Sometimes letting smoke out of themselves.

Beyond the warnings providing by financial wires now getting hot, there has been some flashing hazard lights.

This year's rallies in Lumber and Copper accomplished outstanding gains and have been hit hard. Credit Spreads, which measure the difference between High and Low-Grade Bonds, are close to reversing towards adversity.

The problem with financial wires has been that when the smoke gets out it not just from one wire. It suddenly gets out of wires everywhere and the severity of financial contractions has been proportional to the degree of preceding speculation.

All the great bubbles, of which 1929 was number five, suffered forced liquidation in the Fall of the climax year, when all the wires not only smoked but melted.

For global financial markets, a daunting prospect. Even worse for naive policymakers.