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Can the Market Still Bet on the 'Greenspan Put'?

STREETWISE |

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Shareholders have always been affected by what the Federal Reserve does, but until Alan Greenspan took over, they never expected the central bank to save them from themselves.

Greenspan, who died on Monday at age 100, left a lasting legacy for stock market investors: The Greenspan Put, which morphed into the Fed Put. Named for derivatives that protect investors against price falls, it stems from the recognition that the effects of a stock-market crash threaten monetary-policy goals and, therefore, the Fed should step in and help.

It lasted three decades, but the return of inflation after the pandemic has left a question mark over whether the Fed Put still exists—and plenty of debate about whether it is a good thing.

It started with the Black Monday crash in 1987, when the S&P 500 plummeted 20% in a day. The Fed put out an unusual statement promising liquidity, cut interest rates and asked the banks to lend on easy terms to protect the financial system. Note

The late Chicago economist Lester Telser claimed Greenspan himself was calling round the banks, not only New York Fed President Jerry Corrigan.

"According to what I knew on reliable terms, what Greenspan did is, he was on

Note

the phone that night calling around to the leading banks and telling them, 'I don't want any clearinghouse to fail. I don't want any brokerage firm to go under. You lend to the clearinghouses whatever you need, and we're going to back you'," he told an oral-history project at the University of California, Berkeley.

The idea was a good one, and it worked. Stocks made back about half their losses in a few days, and the economy was untouched. In 1929, the Fed did the opposite, tightening monetary policy after stocks crashed, because it was concerned about the outflow of gold. Bank failures and the Great Depression ensued. Note

Adecade later, the Fed stepped in again when Wall Street was threatened by the failure of hedge fund Long-Term Capital Management. Again, the Fed cut rates and pushed banks to act, with LTCM eventually saved by a bank consortium.

Note

The justification was mostly about avoiding a financial breakdown. But Greenspan also oversaw a Fed that had come to believe in the "wealth channel," that rising stocks made consumers feel richer and spend more. Falling stocks thus hurt consumption.

When the dot-com bubble burst in 2000 the Fed didn't ease, but it did stop raising rates—and cut sharply in 2001 as it worried about the effect on the economy.

Note

Critics argue that the Fed Put creates moral hazard, as investors grow to expect the Fed to step in and so take risks they would otherwise be unwilling to take. Markets thus become riskier after every bailout, as investors are encouraged to believe that the Fed has their back.

I don't think this is really a concern for equities, however. The Fed has demonstrated that it will rescue even midsize financial institutions to save depositors from their bad choice of bank. And it is now clearly the market maker of last resort for the Treasury market, willing to ensure government bonds remain easy to trade. In both areas, investor behavior changes as a result.

But shareholders who expect the Fed to respond after stocks have halved are unlikely to behave very differently from those who think prices could fall to zero.

Either way, for stocks the Put is currently on hold. When the Fed belatedly responded to rising inflation in 2022, it kept going even when share prices fell hard. The S&P fell by a quarter from January to October, but the Fed continued raising for another nine months.

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Because inflation is too high, the Fed is increasingly focused on the inflation part of its mandate. That makes it less willing to support growth with the lower rates shareholders love.

If the next stock-market downturn is severe enough to threaten the economy, and so lower inflation, I'd expect the Fed Put to make a rapid reappearance. But I doubt a mere 20% fall would be enough, and whether it underwrites the economy with stocks down 30%, 40% or 50%, it will come too late for those caught up in a crash.
