

Asset prices suggest that financial conditions are hardly tight.

The Bitcoin Boom and Easy Money

REVIEW & OUTLOOK

If financial conditions are as restrictive as Federal Reserve governors claim, markets haven't received the message. Bitcoin surged past \$100,000 for a day this week, while the Dow Jones Industrial Average is near 45,000. Investors are partying like the high times won't end, and it's hard to blame them when the Fed has promised more lubrication.

Our friends in the financial press are chalking up the Bitcoin rally as a bet on a more crypto-friendly Trump Administration. No doubt the prospect of friendlier regulators contributed to the cryptocurrency's 124% surge this year. But asset prices are high across the board—gold, junk bonds, stocks—often fueled by speculative and leveraged bets.

One of the biggest momentum trades is MicroStrategy's stock, which has gained 464% this year. Despite generating little revenue, the 35-year-old small software firm is valued at \$91 billion. How so? It has amassed a huge Bitcoin reserve, now worth roughly \$41 billion. Investors have piled into its stock as a way to make a bullish bet on Bitcoin.

MicroStrategy in October announced plans to purchase more than \$40 billion in Bitcoin, which drove more buying of its stock and Bitcoin. How does MicroStrategy fund its Bitcoin purchases? With convertible notes that can be exchanged for equity at a later time. Investors buy the notes on the bet that MicroStrategy's stock price will keep climbing.

As with the meme stock rally in early 2021, everything is swell as long as the music keeps playing. But if Bitcoin prices drop and leveraged trades start to unwind, the descent in MicroStrategy shares and Bitcoin may be as sharp as the ascent.

In other words, don't bet your retirement on Bitcoin or MicroStrategy. Bitcoin prices have long been volatile. They tend to rise and fall with broader markets even though the cryptocurrency's supporters tout it as a hedge. Prices crashed some 75% as the Fed tightened in 2022. Bitcoin is soaring now on as monetary conditions ease. There are other signs of market exuberance, rational or not. The Russell 2000 index of small cap stocks has climbed nearly 30% over the last year. These companies tend to be more affected by macroeconomic policy changes, so investors may be betting on strong growth and deregulation.

Still, the index's price-earnings ratio of 36 recalls the dot-com bubble. Expectations of artificial intelligence driving productivity advances might also be helping fuel the euphoria—AI chip-maker Nvidia's stock is up 211% in the last year—but that doesn't explain the rally in high-risk debt.

The last time junk bond spreads over Treasuries were this tight was in 2007 and before that in 1997 when markets were similarly flush with money. There are no signs now of a liquidity shortage. Frothy asset prices and stalling disinflation may even indicate that financial conditions are too easy. The core consumerprice index that excludes food and energy has been stuck at 3.3% since June.

Even the Fed's preferred price gauge, the personal consumption expenditure (PCE) price index, has stopped its downward trajectory. Fed Chair Jerome Powell observed Wednesday that "growth is definitely stronger than we thought, and inflation is coming a little higher" than in September when the Federal Open Market Committee (FOMC) cut interest rates by 50 basis points. Markets interpreted that aggressive cut, followed by 25 more points in November, as a signal that the Fed considered its fight against inflation as won. It's not.

Fed officials are signaling they'll cut another 25 points this month, but we're hard pressed to recall a central bank that cut rates with inflation this sticky, growth this strong and asset prices this gaudy. Caution is advised.

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