Market Madness in the Pandemic

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Paul Krugman 15 juin 2020

After all these years, Hertz is No. 1 again. Not in market share: The car-rental company is a distant second to Enterprise. But Hertz has become Exhibit #1 of the madness that has been sweeping the stock market in these times of Covid-19 — a madness that may do considerable harm, not because stock prices themselves matter all that much, but because Donald Trump and his minions treat the stock market as a measure of their success.

About Hertz: Last month the company, which is deeply in debt and has seen its business plunge amid the pandemic, filed for Chapter 11 protection. This is a form of bankruptcy that keeps a company operating by restructuring its debts.

But while companies that enter Chapter 11 often survive, their stockholders are normally wiped out. So Hertz stock should have become more or less worthless.

Sure enough, Hertz's stock price fell from more than $20 in February to less than $1 in early June. But then a funny thing happened: Investors suddenly piled into the stock, driving it up by more than 500 percent. And Hertz — in bankruptcy! — announced plans to raise money by selling more stock.

The Hertz story was just one example of a broader phenomenon. The run-up in stock prices that took place between mid-May and Thursday's sudden plummet was driven, to an important extent, by investors rushing into very dubious companies — what one observer called a "flight to crap."

Stock markets never bear much relationship to the real economy, but these days they don't seem to have much to do with reality in general.

So what is going on in the market? Think of it as a play in three acts (so far).

The first act was the huge decline that markets experienced as the threat from Covid-19 became clear. This decline reflected justified concerns about future profits, but it also reflected a developing financial crisis: For a few weeks credit markets were seizing up pretty much the same way they did in 2008.

The Federal Reserve, however, has been there and done that. It moved quickly, buying bonds, establishing special lending facilities, and essentially doing whatever it took to lubricate markets and keep money flowing freely.

The result was the second act of the play, a stock rebound that made up about half of the losses from the initial plunge.

Up to that point the behavior of stock prices generally made sense. But then came the third act, a surge in prices that eliminated most of the previous losses and drove the Nasdaq to a new high. And this surge bore all the usual signs of a bubble.

Robert Shiller, the world's leading expert on such things, has pointed out that asset bubbles are, in effect, naturally occurring Ponzi schemes. Early investors see big gains because later investors drive prices up, inducing more people to buy in, and so on; the party continues until something cuts off the flow of new money, and suddenly everything crashes.

So it was with the recent stock surge. Encouraged by the Fed-induced recovery of stocks from their March lows, some investors began buying. Their optimism became a self-fulfilling prophecy, as initial gains led more cautious investors to join in, driven by FOMO — fear of missing out. It looked a lot like the dot-com bubble of the 1990s, except on a vastly accelerated timetable.

Although there is some dispute about how important they were, most of the evidence suggests that a major role in this apparent bubble was played by small investors — "retail bros" — pursuing get-rich-quick dreams. Some of these exuberant investors were people who normally bet on sports and were looking for an alternative source of excitement. And as the Hertz example shows, they didn't care much about quality.

Why didn't large investors offset this apparent irrational exuberance by selling stocks? As John Maynard Keynes argued long ago, staid investors who usually stabilize the market tend to abdicate judgment in "abnormal times." We are, you might say, in a time when the smart money lacks all conviction, while the dumb money is filled with a passionate intensity.

And now the bubble may — may — be bursting. But does any of this matter?

In a direct sense, not much. Stock prices surely have some impact on business investment and consumer spending, but these effects are probably small.

But the Trump team sees stock prices as the ultimate measure of policy success. Back in 2007 — on the eve of the Great Recession — Larry Kudlow, who is now Trump's top economist, declared that things were going great, because the market was up, and stock prices are "the best barometer of the health, wealth and security of a nation."

So the Trumpists took the rising market as validation for everything they were doing — their push for early reopening even though the coronavirus was by no means contained, their opposition to further relief for unemployed workers. In other words, the irrational exuberance of the retail bros may have enabled the irresponsibility of an administration that didn't want to deal with reality in the first place.

And while falling stocks may provoke a reconsideration, a lot of damage has already been done.