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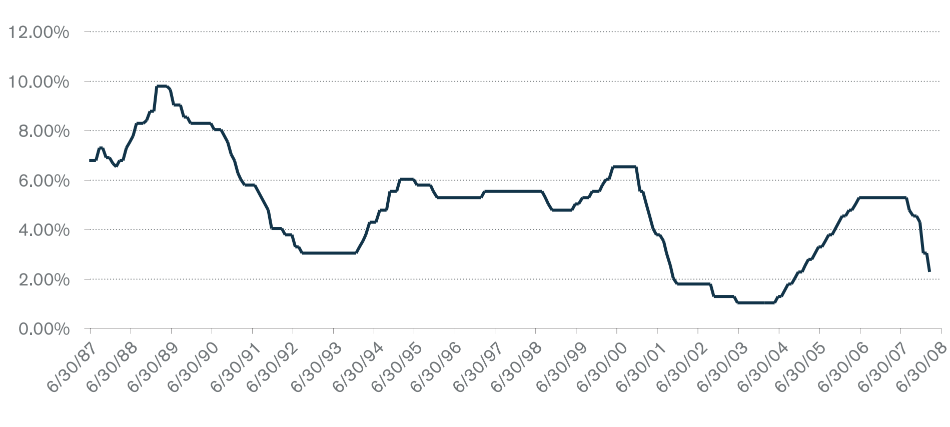
A Tale of Two Eras

Bernanke vs. Greenspan

Returns for our clients who invest primarily in short-term securities are driven mostly by Fed policy. Although it is our job to maximize overall return while minimizing liquidity and capital risk given market conditions, it is the level of the Fed Funds and other short-term rates, along with market expectations for future rate levels, which creates those conditions. Therefore, in order to set correct expectations for future market returns, it is important to understand how the Fed sets interest rate policy.

Much has already been made in the press regarding the shift at the helm of the Fed from Alan Greenspan to Ben Bernanke. A simple search on Wikipedia reveals many of the personal and experiential differences among the two. But it is not enough to know the man—as is true with most leaders throughout history—it is also helpful to understand the challenges they faced in their economic environments.

Fed Funds Target Rate



Source Bloomberg and SVB Asset Management.

THE GREENSPAN ERA

1987 – 1993: THE BIRTH OF A CHAMPION

Alan Greenspan faced a trial by fire when, within just two months of his swearing in, the stock market crashed. Prior to the start of trading on October 20, the day after the crash, he released a one-sentence statement, "The Federal Reserve, consistent with its responsibilities as the nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system."

Recall that this was a time of great uncertainty in the markets as we had recently experienced both double-digit inflation and interest rates. The so-called misery index (simply the sum of the unemployment rate and inflation) sat just north of 10 percent after reaching near 20 percent earlier in the decade.

Not only did we have a new Fed chairman to get to know, but there was a great lack of confidence in Fed interaction with the markets due to the oil crisis and the high interest rates of the late 70s and early 80s. Also, the real estate boom (and later bust) during this period contributed little toward creating confidence in the markets' leaders and the Fed was very tight-lipped in their communication strategy regarding their view on the marketplace.

Unlike today, there was no publicly available Fed Funds target rate and the minutes of their meetings were released so late as to be almost useless. Transparency at the Fed had yet to be conceived and every sizable banking institution had a designated "Fed watcher" on their trading floor whose job it was to divine the Fed's intentions for that day. The Fed could change their interest rate policy at any time—and because there was no stated target rate, Fed meetings were largely ignored by the investing public.

Greenspan took it entirely upon himself to initiate change at the Fed toward more transparency. His goal was to communicate the Fed's intentions in order for their actions to be more effective. Simply put, reducing uncertainty regarding what the Fed wanted would also reduce the risk market participants faced, thereby allowing them to help the Fed implement whatever change they desired. Under this scenario, if the Fed wanted rates to go down, they could simply say so, and the markets would do most of the work for them.

1994 – 2000: "Irrational Exuberance"

At the February 1994 meeting of the Federal Open Market Committee (FOMC) of the Fed, Greenspan introduced a revolutionary change: he issued a written statement that included any changes in the Fed's policy stance. In 1995, the FOMC began explicitly stating its target level for the Fed Funds rate.

This level of clarity was cheered by the markets and deserves much of the credit for the boom of the mid-90s. By eliminating the time and effort wasted, along with the risk created by Fed policy uncertainty, financial market productivity increased solidly. This shift in Fed communications, in combination with many other factors, allowed volatility to begin a steady downward march enabling investors to take more risk in terms of both credit and structure.

During this period, both the S&P 500 and Dow Jones Industrials rose more than 16 percent per annum. The tech- and dot-com-heavy Nasdaq index rose almost 18 percent per annum over the same period, even after accounting for a 50 percent decline during 2000.

During this boom, Greenspan cemented the term "irrational exuberance" in the financial lexicon when he stated:

> *Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price earnings ratios and the rate of inflation in the past. But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions…*

Even as the stock market and economy boomed, inflation declined considerably. The oft-watched core measure that excludes volatile food and energy components dropped from 2.6 percent to a low of 1.0 percent in 1998 before climbing back to 1.5 percent in 2000. How is it possible to have such a "Goldilocks" situation where real GDP averaged 3.8 percent even as inflation slowed? Answer: worker and technological productivity.

Demonstrating excellent forethought during this period Greenspan held interest rates lower than most financial models demanded due to the ongoing productivity miracle. His reasoning was that increasing productivity created a disinflationary environment allowing growth in the economy to continue at a faster pace before price pressures appeared en masse.

Some say Greenspan is to blame for the market crash of 2000 and 2001. First, he allowed the bubble to inflate and then he was forced to puncture it as "risks to sustainable growth" appeared. We will leave that for history to decide; however, one wonders where our economy would be today had the Fed kept their foot on the brake during the nineties thereby cutting off much of the risk taking and entrepreneurship.

2000 – 2005: Holding on to a Legacy

In reaction to the already-slowing economy and the terrorist attacks of 9/11, the Fed worked aggressively to meet the market's daily needs for liquidity and orderly operations. Eventually dropping interest rates to 1 percent, the Fed narrowly avoided a textbook-defined recession — that is, two consecutive quarters of negative growth — when the fourth quarter of 2000's measure was revised upward to +2.1 percent. This meant the only recession Greenspan oversaw occurred in late 1990/early 1991 — a result of the U.S. Savings and Loan crisis.

Even as the economy eventually recovered in 2002 and 2003, inflation continued to remain tame in the low- to mid-1-percents. In mid-2004, as the economy was steadily growing led by the housing market, the Fed began to systematically increase interest rates 25 basis points at a time. In total, the Fed would raise rates at each meeting between June 2004 and June 2006 for a total of 4.25 percent, or 17 increases, to 5.25 percent. This, of course, included four increases during Bernanke's tenure.

The disinflationary environment effective throughout most of Greenspan's tenure was surely over-inflation could not go much lower. This ushered in a new era of low expectations for inflation just as Bernanke came into office.

THE BERNANKE ERA THUS FAR...

In contrast to Greenspan's 1987 stock market crash, Bernanke has not had an opportunity to "earn his chops" with the markets until recently. Bernanke's big test is certainly the recent series of events: the housing bubble bursting and the seemingly continuous demise of investments which consist of convoluted financial contracts and market-dependant liquidity facilities. We cannot yet judge how he will fair, but it is quite important to understand that Bernanke faces primary challenges that no other recent Fed chairman has had to endure: investor and consumer expectations.

As an economic society, we have become quite spoiled by the Greenspan era of high-productivity growth combined with low inflation. Today, investors and consumers alike fully expect inflation to remain low and growth to remain high. When this is not the case, as it is today, fear completely takes over the investor's thought process driving liquidity away from those investments that need it most

No matter that GDP grew at a 2.5 percent annual rate in 2007 and our last negative growth print was 2001. Yes, the economy is slowing as evidenced by year-over-year nonfarm payroll growth dropping from 1.7 percent to 0.7 percent earlier this year, but we've only had two months with a drop in overall payrolls during this cycle. Even the almighty consumer is hanging in there as retail sales grew an admittedly weak 0.6 percent in the fourth quarter even as the bond markets cried "wolf" driving credit spreads to recent wides. Obviously the economy is slowing, but a text-book defined recession — that is two consecutive quarters of negative growth — is far in the distance assuming an engaging and active Fed.

Just two months prior to the Bernanke 50 basis-point rate cut in September, the markets had placed a near zero chance of any rate cuts for the foreseeable future and he has cut interest rates a total of 300 basis points thus far. In addition, the Fed has created several new lending facilities to provide high quality collateral to those who need it, loans to non-banking institutions (for the first time since the Depression), and to compete directly with market-set interest rates such as LIBOR in order to drive costs downward. How's that for an engaging and reactive Fed?

GOING FORWARD

Bernanke's unique challenge for the remainder of his term is to navigate the ups and downs of the economic cycle while managing the ever-demanding expectations of consumers and investors. Primarily, the risk to failing these expectations over the long run falls on the side of allowing inflation to rise higher than people had believed possible.

Imagine the effect on project evaluation should CFOs begin to think 4 or 6 percent inflation a possibility? All of a sudden, projects that looked profitable before begin to fall well within "negative NPV" territory and entrepreneurial growth is chopped off. Additionally, higher interest rates that would necessarily accompany higher inflation make big ticket purchases much less attractive to consumers, further slowing economic growth.

But the real problem is a "re-setting" of inflationary expectations. The Fed has worked diligently for over two decades to reduce the risk of uncertainty in the markets and once that genie is out of the lamp it will take a long time for the chairman to replace it. Today, there are twelve years left on Bernanke's original fourteen-year appointment and we do not believe he wants to spend the bulk of that time fighting this battle.

All this implies that the Fed will need to err on the side of higher interest rates over time in order to keep inflationary expectations in check. Though the whining residents of Wall Street will protest, the risk of higher inflationary expectations will occupy more of Bernanke's worry bucket than slower growth.

Assuming we are correct, his credibility will deteriorate even in the good times due to higher than "normal" interest rates creating an awkward position when the economy does turn south. Once it becomes clear the economy is in a steady downtrend, Bernanke will have to react swiftly and aggressively in pursuit of avoiding recession in order to preserve his personal credibility as Fed chairman.

This is exactly what is happening today. Having already cut interest rates by 300 basis points and instituted several new lending resources for the markets, Bernanke is aggressively pumping liquidity into the financial system in order to quickly address today's financial issues. The trouble is that it will take more than cheap funding to create a recovery in the housing sector and only time will heal this pain. In the meantime, the Fed is flirting with the inflation beast and will have to act quickly once the markets and economy recover.

CONCLUSION

In comparing the two eras, we see the Bernanke version including slower growth, more aggressive rate hikes and cuts, and a perpetual longing for the good old days on Wall Street filtering into your local newspaper. Like any man of power, Bernanke will be judged and re-judged over time, but the true test of his success will be his ability to manage through excessive expectations on the part of both investors and consumers.

While the Bernanke era will include slower growth — if we are correct — it will also include interest rates that are at a higher level than we've become used to under the Greenspan era. This translates into higher investment yields and higher interest income for our clients.

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