

Market Outlook

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Alan Greenspan's Medal: Gold, Silver, or Bronze?

Alan Greenspan retired at the end on January, capping what may have been one of the most celebrated tenures of any modern Federal Reserve chairman. He has had an aura of an invincible, all knowing financial demi-god, to whom America counted on for guidance though the many financial storms that blew in over the past 18 years. His baptism by fire occurred with the 1987 stock market crash, just a few months into his new job. That was quickly followed by the Latin American debt crisis of the late 1980s, the 1990 invasion and liberation of Kuwait, the massive rate tightening of 1994, the dot.com boom and bust, Y2K, a historic bear market in stocks followed by equally historic low bond yields, 9/11, a housing boom, the Iraq war and subsequent skyrocketing of energy prices. It is no wonder he has been anointed as the preeminent financial leader of our time, enjoying a positive reputation that any politician or CEO would gladly for (which, of course, some do).

But how will history judge Greenspan? It is easy to look his tenure as Federal Reserve chief and conclude that nobody could have done it better. Certainly it was

a gold medal performance, not just for skill, but also longevity. How could the judges vote otherwise, even easily persuaded skating judges from France?

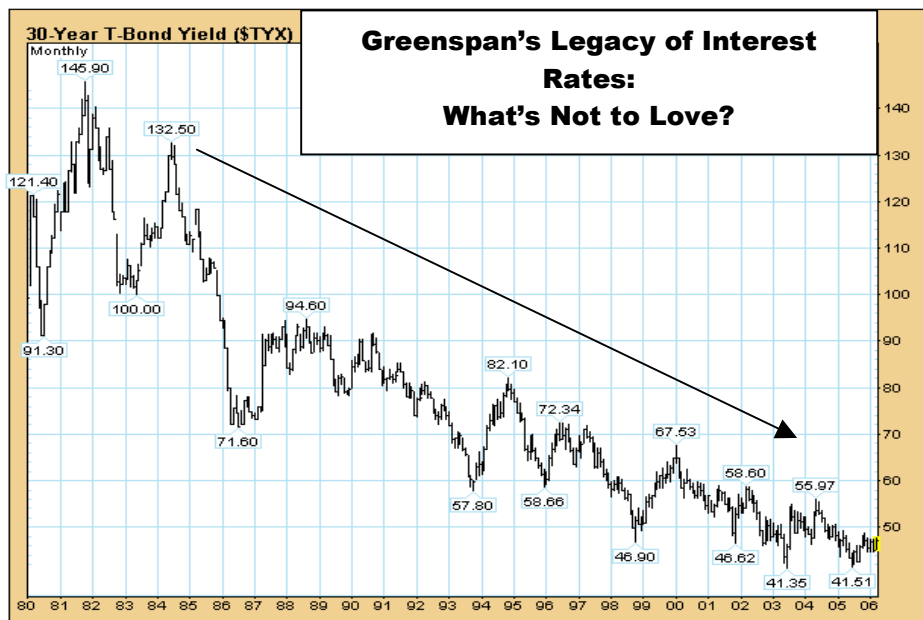
I believe that history will award Greenspan not a gold medal, but one of tin. Through the sober reality of time's passing, his performance will be seen to have been timid, politically influenced, and even somewhat reckless. This judgment will befall him

as the consequences of the Fed's policies of the past 18 years will have to be dealt with by current and future generations.

Financial markets have a way of lionizing the policymakers that make us feel good, and vilifying those that inflict pain. One of the clearest examples of this was Greenspan's predecessor at the Fed, Paul Volcker.

In the late 1970s, Paul Volcker presided over an economy going through a painful transition from a manufacturing industrial base to a service economy. Moreover, the US was dealing with Japanese competition and the worst price inflation of modern times. The 1970s have become synonymous with the rampant inflation and ingrained inflationary expectations. Remember gold at \$800 an ounce, the wild speculation in real estate, and stock prices with single-digit price earnings ratios? This was what Volcker had to deal with, and ultimately he provided the necessary leadership to "break the back of inflation." Unfortunately, it required raising interest rates to the highest levels since the Civil War to demonstrate that the Fed meant business. Volcker was viewed as trying single-handedly to ruin the US, send it

into a depression, and destroy the Treasury bond market. Far from being loved, he was viewed as a cigar-chomping Rasputin in pinstripes, a central banker gone mad. But, as history has shown, he took absolutely the right path to deal with the problem the country faced.



Volcker's policies laid the groundwork for the 20-year bull market in bonds that Greenspan has enjoyed. The

accompanying chart shows why Greenspan is revered as a champion of growth: interest rates have been falling for a generation, provided a powerful tailwind for consumption, capital investment, and stock prices. From a high of 14.5% in 1981, long-term bond yields had fallen to 4.1% in 2003. Greenspan has enjoyed almost the entire decline in rates, and certainly engineered their decline to record lows in the early 21st century.

This gave him a powerful weapon against almost any financial calamity. He was able to open the monetary spigot and flood the system with money when financial distress threatened. This occurred in the wake of the 1987 crash, numerous currency crises, the Russian debt default and collapse of hedge fund Long Term Capital Management in 1998, and the trauma of the 9/11



terrorist attacks. Each case was a bona fide financial crisis, which Greenspan deftly “solved.” In each case money supply jumped, interest rates plunged, and the flood of liquidity allowed liabilities to be paid or restructured. He would not have had this luxury in a rising interest rate environment.

The Fed, as a result, created a “moral hazard.” Moral hazard is the name given to the increased risk of problematical (“immoral”) behavior, and thus a negative outcome (“hazard”), because the person who caused the problem doesn't suffer the full (or any) consequences. After the Greenspan strategy of monetary easing became clear, it had the perverse effect of encouraging risky lending among banks (S&L bust of late 1980s), Wall Street (junk bond problems of 1990 and 2001), and government (witness the ballooning budget deficit).

Such aggressiveness spilled over into the consumer sector in the 1990s, and was brought to the boil by record low mortgage rates over the last 3 years. The refinancing boom has encouraged Americans to borrow against their assets (real estate) in order to finance consumption. Embarrassingly, our country has one of the lowest savings rates of any industrialized nation, despite a low unemployment rate and high productivity.

Perhaps the greatest debate over the Greenspan years will be the fact that Fed policies contributed to two asset bubbles during his reign, stocks in the late 1990s, and real estate today. Asset price inflation has become the “new” inflation in the US. Thanks to globalization, new technology, and US economic flexibility, all of which have kept goods prices low, cheap money has not spilled into traditional inflation, but into rising asset prices instead. Though the Fed specifically targets low prices, asset price inflation can be as harmful as traditional price inflation. Surging asset prices can distort price signal and cause a misallocation of resources, by encouraging too little saving, or too much investment in the speculative asset *du jour*.

A combination of low (negative) household savings, a growing burden of household debt, and a huge trade deficit have left America with the greatest economic imbalances in its history. Part of America's current prosperity is based not on genuine gains in income, nor on high productivity growth, but on *borrowing from the future*. The Greenspan legacy are nicely summarized in the words of Ludwig Von Mises, an Austrian economist of the early 20th century: “It may sometimes be expedient for a man to heat the stove with his furniture. But he should not delude himself by believing that he has discovered a wonderful new method of heating his premises.”

