

Market Outlook

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Walking Through the Valley of the Shadow of Greenspan

For 18 years, Alan Greenspan did his best to discuss Federal Reserve Bank policy without really tipping anyone off as to what it really was. His noncommittal and roundabout way of answering questions of both Congress and Wall Street spawned a mini-industry devoted to deciphering the hallowed utterances of one of the most admired financial figures of modern times. Obfuscation was a byword of his public pronouncements, leading to weeks, if not months, of debate as to whether he meant the Fed was leaning one way or the other.

Greenspan's motto could have been "Speak mysteriously and carry a big stick." And that "big stick" was the manipulation of monetary policy to deal with crises. He understood the power of lowering rates and injecting massive amounts of monetary liquidity into the economy in order to turn a major financial accident into a short-term opportunity to "buy the dips."

Shortly after succeeding Paul Volcker in 1987, the stock market suffered one of the greatest one-day percentage drops in its history. The Fed adeptly opened the monetary spigot and prevented it from spilling over into the "real" economy. In 1998, Russia defaulted on their government bonds, causing a hedge fund named Long-Term Capital Management to implode. Again the Fed turned on the hose of liquidity to keep the financial domino effects at bay. And in the wake of the 9/11 attacks, the Fed lowered interest rates dramatically to keep the banking system solvent and prevent financial panic. In retrospect, one must say that Greenspan's big stick worked. In fact, it worked too well.

So accustomed had the financial markets become to the Fed's response of loosening the monetary spigot to deal with these crises that they coined a term for the policy: *the Greenspan put*. The "put" is derived from a security of the same name that allows the holder to "put" shares of a stock to another investor at a predetermined price, in effect putting a floor under the stock price. It is a tool used to protect against the downside risk in a stock. In terms of the Fed, it meant that investors in each crisis would be bailed out by lower rates and massive liquidity injections. Investors caught on to this "put" in the

1990s, and, perceiving their downside risk was limited, took on much more risk than they would have otherwise. The boom in emerging markets, the dot.com bubble and the current heartache in the mortgage market all owe their roots to this tendency of the Fed to underwrite the *moral hazard* of investing.

No, *moral hazard* does not refer to the risk of sharing a Minneapolis Airport bathroom with a certain Idaho senator, but rather the idea that when another party ensures there will be no downside risk, investors will indulge in riskier behavior and be less careful than if they knew they had to shoulder the entire risk of failure. The Fed's reactions to crises, i.e. a flood of liquidity, have exacerbated moral hazard in the marketplace.

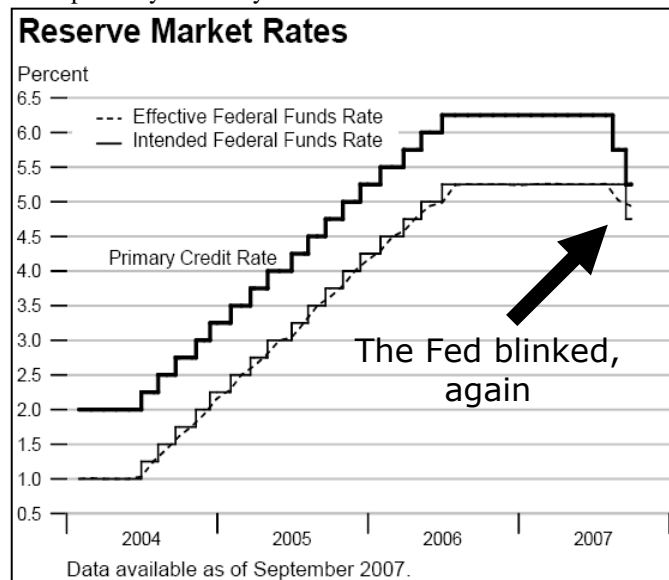
The Greenspan Fed has injected moral hazard into global markets, which causes speculative bubbles to form. Of course, bubbles don't last forever, they are bound to burst.

The latest bubble to burst is the US residential housing market, brought on by the extremely low interest rates of 2003-2005. The Fed kept rates very low to deal with the recessionary effects of the technology stock bubble bursting, which was partially fed by the stimulative Fed policy leading up to Y2K, which in turn was fueled by the stimulus provided to deal with the Asian currency crisis of the

late 1990s. (Does anyone notice a pattern here?) While it can be argued that a stock market decline affects relatively few American households, the same cannot be said for a decline in house prices. As the news gets grimmer by the day in the world of real estate, the "wealth effect" of falling home prices may be profound. As people feel poorer due to falling house prices (real or perceived), they tend to cut back on non-essential items such as fashion clothing and restaurant dining. The fear, of course, is that this may have a negative feedback effect and cause reductions in overall spending. Given that the consumer sector is about 70% of the economy these days, this is no idle worry.

WWAD (What Would Alan Do?)

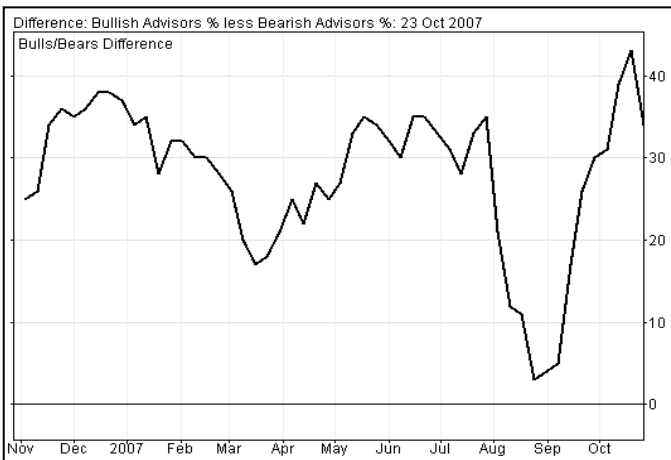
Whether by default or by design, the current bubble was laid at the feet of Ben Bernanke, Greenspan's successor. A relatively unknown policymaker, Bernanke had enormous shoes to fill, and calmed the markets by maintaining a "steady Eddie" policy on interest rates, rather than continuing the ratcheting up begun



by Greenspan in 2004. Much like the successful father who brings his son into the business, Bernanke has been judged through the lens of what “father” Greenspan would have done. Every statement, public appearance and policy move has been judged in this context, and has made it seemingly difficult for Bernanke to bring a sense of new independence to the Fed.

Indeed, Mr. Bernanke has not given the markets any sense that he is independent of the old play book. This was exemplified by the Fed’s surprise rate cut of 0.5% in August as the fallout from the subprime mortgage speculation reached critical mass, and the debt markets began to freeze up. Loans couldn’t be bought or sold, removing a crucial prop to the modern mortgage financing market. As numerous hedge funds began to fold under the weight of their rapidly evaporating asset values, stocks were taking multi-percentage drops every day, and severe panic began to set in among investors.

Then the fed blinked. In classic Greenspan fashion, he gave the markets what they wanted: a big rate cut and tons of liquidity to help grease the skids of finance, and relieve the bond market gridlock. Once again, the speculators and hyper-leveraged hedge funds had been bailed out; moral hazard was alive and well. There was no need to worry about the downside, because the Fed would protect against it. The result was a robust rally in stocks and bonds that had overly bearish investors scrambling to catch up with the major indexes. The schizophrenic nature of the markets is obvious when one



realizes that despite being down 10% within 2007’s 3rd quarter, most indices finished with positive returns for the period! A differential of bullish sentiment, measured by Investor’s Intelligence (above), had rocketed from despair (3%) to a 5-year high of 42% in less than two months. The Dow, S&P 500, and NASDAQ 100 all moved to new yearly highs, despite no resolution of the underlying mortgage risk for Main Street homeowners. By early October the prevailing bullish attitude reminded me of Mad Magazine’s iconic Alfred E. Neuman, whose motto was “What, me worry?”

The Fed in a Box

The Fed’s job is morphing into something other than their stated goal of defending against inflation. They have become

the rescuer of last resort for speculators. Unfortunately, this comes at a time when the risks of inflation are higher than in a decade.

Higher energy and food prices are the raw materials that feed into higher future prices, and these show no signs of abating. The Fed seems to be fiddling while Rome’s inflation burns.

If the Fed is diligent about inflation risks, they will ultimately have to forego their role as enabler of moral hazard in the markets. For interest rates will have to rise to deal with price inflation, in direct conflict with a market addicted to a stimulative Fed.

Moreover, inflationary expectations are becoming more entrenched. Think of how many of your friends and acquaintances are now factoring inflation into their thinking, a behavior brought on by the reality of rising prices. I believe the “official” calculation of inflation is flawed, and that this will ultimately catch policy makers off-guard

The Fed is in a box because:

- 1) the economy is highly leveraged, and is dependent on accommodative interest rates;
- 2) higher rates hurt a leveraged economy;
- 3) “Official” inflation will probably surprise on the upside before the Fed acts;
- 4) The Fed is unlikely to do anything upsetting in a presidential election year.

The Fed will eventually need to sacrifice providing soothing balm to Wall Street in a return to the fight against inflation, but when remains an open question.

For anyone that has had to buy food, gasoline, or a restaurant meal, you are on your own when it comes to dealing with future inflation. Greenspan’s monetary policy has cast a long shadow, and the best portfolio strategy is to assume the game of moral hazard cannot be played indefinitely.

