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U.S. MARKET COMMENTARY

THE FED'S REFLATIONARY EFFORT: WILL IT WORK AND WHAT ARE THE RISKS?

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"Monetary policy should make even a fiat currency behave 'as though anchored by gold'."—Alan Greenspan, *The Age of Turbulence*, quoting his congressional testimony.

"To understand the Great Depression is the Holy Grail of macroeconomics…. [T]he experience of the 1930s continues to influence macroeconomists' beliefs, policy recommendations, and research agendas."—Ben S. Bernanke, "The Macroeconomics of the Great Depression: A Comparative Approach," *Essays on the Great Depression*.

The Concept of "Reflation"

"Reflation" is an oft-used but little-defined term. While there would be little argument that reflation refers to a government's monetary efforts (generally lowering interest rates and/or increasing the money supply) to stimulate demand and boost economic activity, there would be much more discussion as to whether the term includes fiscal measures and whether or not deflation or deflationary trends need be present for "reflation" to occur. These distinctions aside, we use reflation herein to mean government actions to pump up demand, thereby increasing economic activity. Our focus is on monetary policy, although we recognize that fiscal measures may also play an important role in reflationary policy.[1]

While the idea of pumping up the economy through government spending has Keynesian roots, the intellectual framework behind the idea that monetary easing can be an effective response to economic downturns rests in part upon the commonly held view, based on the work of Milton Friedman and Anna Schwartz, that the Fed should have pursued a much more expansive monetary policy during the Great Depression. Fed Chairman Ben Bernanke is a strong adherent of this view, as he made clear on the occasion of Friedman's 90th birthday party.[2] We believe, however, that the Fed's current reflation policy substantially increases the risk of both short- and long-term inflation. This makes it important for investors to consider whether they have adequate inflation protection, even as the combination of the credit crunch and structural problems in the U.S. economy has increased the risk of a deflationary bust.[3]

[1] It is also worth noting that reflation is consistent with the popular view that some small level of inflation is acceptable, perhaps even optimal, for steady economic growth.
[2] It was on this occasion that Bernanke delivered his well-known *bon mot*, "I would like to say to Milton and Anna: regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again." "On Milton Friedman's Ninetieth Birthday," remarks by Governor Ben S. Bernanke at the Conference to Honor Milton Friedman, November 8, 2002.
[3] For a more in-depth discussion of our views on deflationary risks, please see our April 2008 Market Commentary *The Eye of the Storm*.

Fed Reflation Past and Present

The post-Volcker Fed's[4] reflationary policies have reflected its strong belief that rates can be adjusted not only to fight inflation but also to help the economy avoid a hard landing—in short, to smooth the business cycle. In all three cases since 1987 where it saw the risk of a significant economic downturn, the Fed cut rates aggressively (Table A).[5] In late 1990–91, it lowered the Fed funds target rate (the overnight lending rate at which banks should be able to borrow from each other)[6] to 6.00% from 8.25% over a six-month stretch. Similarly, the Fed initiated a rapid series of rate reductions in 2001, bringing the Fed funds rate to 1.75% from a starting point of 6.5%.

Likewise, after having held both the discount rate (the rate at which banks can borrow from the Fed) and the Fed funds rate constant for over 13 months, the Fed decided last summer that the risk of a sharp economic downturn stemming from problems in the housing market and the effect of the subprime meltdown on credit markets more broadly necessitated action. The Fed therefore approved a 50 basis point (bp) reduction in the discount rate in mid-August and subsequently approved a series of further cuts totaling 350 bps. Starting in mid-September, meanwhile, it reduced its target Fed funds rate to 2.00% from an initial level of 5.25%.

Consistent with Bernanke's preference for quick rather than drawn-out policy actions, the Fed arguably has been much more proactive during the current cycle than it was in the two aforementioned downturns. For example, two of its cuts were 75 bps each, the largest since the Fed began reporting rate cuts.[7] Moreover, whereas in both 1990 and 2001 the Fed clearly acted to counter a cyclical economic downturn that was already underway—as reflected by negative real GDP growth—its decision this time around came at a time when real growth actually remained strong (4.9% on a seasonally adjusted annualized basis during the third quarter). Indeed, real GDP growth has remained positive, though anemic, during the last two quarters. Likewise, growth in the reported real earnings of the S&P 500 was weak but not yet negative when the Fed cut rates in September, unlike the case in 1990 (five consecutive quarters of negative real growth) or 2001 (one quarter) (Table B).[8] The Fed's actions since last summer can be attributed in large part to its concerns about the stability of the financial system and the potential repercussions of financial instability on the broader economy.

In addition, whereas its 2001 press releases focused on sales, production, consumer confidence, profit margin, and inventory figures, Fed statements this cycle (at least through the end of 2007) have focused primarily on strains in financial markets and the potential effect of the housing correction, with minimal reference to the more traditional indicators of an economic slowdown. The 2001 Fed referred

[4] Paul Volcker stepped down as Fed Chairman in 1987 and was replaced by Alan Greenspan. Greenspan served until January 2006 and was succeeded the following month by Ben Bernanke.
[5] Until 1993, the Fed only published brief summaries of its policy actions regarding rates in an annual report.
[6] Unless otherwise specified, rate cuts discussed herein refer to the Federal funds target rate or its counterpart rate in other countries or regions.
[7] Data on the Fed's target policy rate go back to 1990. The Fed *hiked* the Fed funds rate by 75 bps once, in November 1994.
[8] Earnings growth had been essentially flat, however, in the first two quarters of 2007 and ended up falling sharply in the third quarter, as the Fed likely estimated it would when it made its decision.

frequently to inflation pressures remaining contained (producer and consumer[9] prices actually dropped significantly in 2001, as they had in 1991); the 2008 Fed has downplayed rising inflation during the present cycle (Tables C and D).

Finally, the Fed has also taken several extraordinary measures since December that, although perhaps directed more at preventing a systemic breakdown, can also be considered "reflationary" by virtue of their focus on increasing market liquidity. For example, in December the Fed eased borrowing requirements for commercial banks by creating a Term-Auction Facility that allows them to borrow anonymously twice a month at a rate between the Fed funds rate and the discount rate. In March the Fed extended to 90 days (from 30 days) the maximum maturity of loans to commercial banks. That same month the Fed broadened its reach to primary dealers, first by establishing a Term Securities Lending Facility, a mechanism through which the Federal Reserve Bank of New York (FRBNY) can lend Treasury securities to primary dealers for 28 days in exchange for "a broad range of investment-grade securities" that can include "federal agency debt, federal agency residential-mortgage-backed securities (MBS), and non-agency AAA/Aaa-rated private-label residential MBS," and then by agreeing (again through the FRBNY) to provide overnight funding to primary dealers through its new Primary Dealer Credit Facility. This is the first time since the 1930s that the Fed has extended direct financing to nonbanks. The Fed (actually the FRBNY) also essentially agreed to backstop J.P. Morgan's purchase of Bear Stearns by assuming the risk of loss on up to $29 billion of securities held by the latter institution.

Comparing Fed Policy With That of Other Central Banks

Fed rate policy during the current downturn contrasts much more with that of other central banks than was the case in 1990–91 or 2001 (Table E). In 1991, the Bank of England (BOE) cut even faster than the Fed while the Bank of Japan (BOJ) began cutting rates nine months after the Fed started.[10] In 2001, meanwhile, the Fed's concerns were broadly shared by its counterparts. The BOE began cutting rates in February (just one month after the Fed started) despite still solid economic growth. Although Japanese policy rates were only 0.25%, the BOJ dropped rates by 10 bps that same month. The European Central Bank (ECB) followed suit in May 2001 in the face of virtually flat economic growth.

In the current crisis, however, the other major central banks are standing pat (ECB and BOJ) or cutting only slightly (BOE). A number of other central banks, meanwhile, are *increasing* rates to counter inflationary pressures. Nevertheless, there is broad agreement among the major central banks regarding the need for extraordinary measures to ensure market liquidity and, in fact, there has been significant central bank coordination in this regard. Since August, for example, the ECB has sought to ensure liquidity by keeping very short-term money market interest rates down, adding supplemental refinancing operations, and providing money (in both its main and its supplemental refinancing operations) for longer periods. The ECB has also for several years accepted less-creditworthy collateral in its refinancing operations. The BOE also increased the size of reserves offered in open-market operations and, similar to the Fed, expanded the range

[9] We refer here to overall prices rather than consumer prices. Core CPI actually rose slightly in 2001.
[10] The Bundesbank, however, raised rates in 1991–92 in response to strong German economic growth.

of "high-quality" securities it would accept as collateral against funds advanced at the three-month maturity to include instruments such as AAA-rated tranches of prime residential MBS and asset-backed securities backed by credit cards. In April, the BOE went a step further, announcing that for the next six months banks could temporarily (for one to three years) swap their high-quality mortgage-backed and other securities for U.K. Treasury Bills.

To address the impact of funding-related currency issues, meanwhile, the ECB, BOE, Swiss National Bank, and Bank of Canada agreed with the Fed in December to take joint action to provide dollar funding to Eurosystem counterparties. This action was coordinated with other G-10 central banks such as the BOJ.

Will the Fed's Reflationary Policies Succeed?

While some have questioned (or excoriated) what they call a permanent and dangerous easy money policy,[11] theirs has been a distinctly minority view. In part this is due to the fact that following substantial rate cuts in 1990–91 and 2001 the U.S. economy eventually staged recoveries (though the latter one was the weakest in the postwar period), lending substantial credibility to the Fed's reflation approach. It is of course too soon to know whether the Fed's policies in the present instance will be considered a success. Following a dismal third quarter in which the real corporate profits of the S&P 500 fell (on a quarter-over-quarter basis) 7.5%, profits fell another 16.4% during fourth quarter 2007, the eighth worst quarter ever in real terms, and fell another 0.3% during first quarter 2008.[12] Real GDP, however, remained slightly positive (0.6% on a seasonally adjusted annualized basis) during both fourth quarter 2007 and first quarter 2008.

The Fed continues to face an enormous challenge in the wake of the housing contraction, the subprime blow-up, and widespread confusion over the quantity, whereabouts, and current value of credit-related exposure. Arguably, the Fed has prevented a systemic meltdown that could have had severe and long-lasting consequences for both the U.S. and world economies. However, the success of the Fed's reflationary efforts is more doubtful. For starters, interbank lending remains strained, as shown by the fact that lending spreads are now (and for the past eight months have been) much wider than was the case historically. This phenomenon is also present in other developed markets, indicating that the problem is now a global one (Table F). As Bridgewater Associates noted recently, "The rates facing [U.S.] consumers and most businesses are not much different than they were last August, and the ability to get any credit at all is much reduced."

Indeed, although U.S. banks (which borrow short and lend long) should benefit from the steeper yield curve that has resulted from Fed rate cuts (since long-term interest rates have been little affected) they are in fact trying to *delever* rather than grow their balance sheets through lending. Borrowing by U.S. households and nonfinancial corporations has plummeted.

[11] With respect to the current Fed easing, it is worth noting that the supply of money, as measured by M1, is barely growing because the Fed has apparently sterilized its interventions. However, by the broader M2 measure, the money supply is now growing faster than in 1990.
[12] Our data begin in 1900. The figure for first quarter 2008 is preliminary.

The continued strains in lending reflect deep-rooted problems in the financial sector. Given such problems, together with what may well be a lengthy downturn in the housing market,[13] Fed assumptions regarding the efficacy of reflation in the current economic environment—which are shared by other U.S. government policymakers—may well be overly optimistic.[14] By all estimates the U.S. financial system still needs to purge itself of hundreds of billions of dollars of illiquid, overvalued assets (housing-related derivatives, leveraged loans, and the like) while simultaneously recapitalizing itself. Since the success of monetary reflation is contingent upon financial intermediaries passing along the benefits of easier money to businesses and consumers, however, it will not work as well as the Fed hopes, let alone succeed, until financial sector health is restored.

Even should consumers and businesses find it easier in the months ahead to access capital, there are a number of other obstacles to the success of the reflation policy of the Fed and indeed the U.S. government as a whole.[15] The rise in corporate defaults and likely reversion of corporate profits from recent peak levels will negatively impact business spending. And while nonfinancial business balance sheets are in decent shape, consumer finances are not. Consumer savings levels have been alarmingly low or negative for some time. The plummeting of housing prices has now left consumers without a means of financing their spending. Meanwhile, unemployment is on the rise and, as a lagging indicator, is likely to increase for some time after the economy bottoms out. This too will work as a brake on consumption. Reflationary policies also have not yet succeeded in shoring up consumer confidence. In fact, by one widely followed measure, U.S. consumer confidence is at its lowest level in 26 years.[16] Higher inflation expectations may be one cause of this negativity.[17]

Risks

The Fed has taken extreme measures because it fears not just an economic downturn but, potentially, a deflationary contraction resulting from the potent cocktail of the credit crunch, the ailing financial system, the uncertainty surrounding how the huge numbers of new financial instruments will perform in a down cycle, and the broader impact on the economy of the wrenching downturn in the housing market. This explains the Fed's fear of the potential consequences of a major prime broker failing and its consequent decision (with the U.S. Treasury) to bail out Bear Stearns and institute a direct lending channel to prime brokers. The Fed appears to be playing for time, pulling out all stops to at least allow the financial system to stabilize, thus removing (hopefully) any possibility of some kind of 1930s-style meltdown.

[13] We highlighted the severity of financial and housing issues in our December 2007 Market Commentary *The Dénouement Begins*.
[14] For a broader discussion of these assumptions, including the interaction between U.S. and global growth, please see our April 2008 Market Commentary *The Eye of the Storm.*
[15] The Bush administration and Congress's reflationary policies include, for example, the impending tax rebates and various initiatives to expand mortgage lending.
[16] Reuters/University of Michigan Surveys of Consumers, April 2008 press release.
[17] According to *Forbes,* the Reuters/University of Michigan Surveys of Consumers (April 2008) also showed that one-year inflation expectations rose half a percentage point in April to 4.8%, the highest level since October 1990.

The Fed believes that these risks outweigh inflationary pressures, that an economic contraction may in fact exert downward pressure on prices, and that, even if this does not happen, it will be able to control inflation later, if necessary. We are less sanguine. In our view, the Fed's reflation policy carries significant short- and long-term risks. Slashing rates—which are already much lower than those prevailing in the United Kingdom and Europe—at a time when most other central banks are not doing so has certainly contributed to the dollar's ongoing decline (Table G) and has likely fueled core inflation, which has been above the unofficial target level of 1% to 2% for some three-and-a-half years. The weak dollar is reflected in vastly higher commodity prices, a particularly risky proposition these days given both significant supply constraints and structural factors (e.g., rapid growth in emerging markets, particularly China and India) that are driving an increase in demand. Thanks to these trends, producer and non-core consumer prices have been running at levels not seen since 1981 and 1990, respectively (Table C). In a major shift, the United States now appears to be importing inflation from other nations as prices rise globally and the dollar weakens. Indeed, former Fed Chairman Paul Volcker, whose tight money policy helped rescue the United States from the stagflation of the late 1970s, recently likened the present situation of rising commodity prices and loose monetary policy to that pursued so disastrously in the early 1970s.

Even if the Fed's reflation policy is successful in promoting economic growth, high inflation would have serious effects upon the American worker and consumer. Real purchasing power could decline significantly and, if the dollar did not behave, as Greenspan wrote in the quote with which this paper begins, "as though anchored by gold," the Fed could also lose its hard-earned credibility on inflation, making its job much more difficult. Failure on the inflation front would likely impact global markets outside the United States as well. Of course, the Fed's inflation-fighting credentials are not all that is at risk. By accepting potentially hundreds of billions of dollars of risky assets in exchange for Treasury securities the Fed has seriously weakened its balance sheet. Indeed, over the course of just a few months the percentage of Treasury holdings as a percentage of the Fed's credit dropped by over 20 percentage points to 70% as of March 26, 2008.

Success in avoiding a deep economic downturn might also prove only temporary and indeed illusory (in the sense that it might be seen to have addressed structural economic problems) should Fed policy turn out to have merely created the conditions for a bubble in some other asset class(es) that would later prove even more problematic to resolve. Moreover, given that most other central banks see inflation as a bigger threat than slow growth, Fed policies could also potentially damage the dollar's long-standing status as the world's major reserve currency.[18]

By cutting so quickly from a relatively low starting point the Fed has also not left itself with much room to maneuver should conditions continue to deteriorate. (Indeed, this may be why the Fed appears to be either slowing down or pausing.) The Fed funds rate was only 5.25% when the current rate-cutting cycle began, well below the 8.25% and 6.5% levels when the Fed acted in 1990 and 2000, respectively. The Fed could therefore soon find itself pushing on a string.

[18] To some degree, this transition has already started, as central banks have begun the process of diversifying new reserves away from US$ assets. For a more complete discussion please see our October 2007 Market Commentary *Does the "Buck" Stop Here?*

Conclusion

Indeed, commentators on the U.S. economic scene are increasingly offering up analogies to the long post-1989 period of Japanese decline during which an easy money policy was wholly ineffective. Yet while Japan only now seems to be emerging from deflation, we believe the larger risk to the United States is inflation. Our conclusion is based upon the Fed's deep aversion to deflation and concomitant commitment to a reflationary policy, our belief that reflation is likely to stimulate the economy at least in the short term, and our sense that the world has entered a period of structurally higher prices. The Fed's clear focus on growth rather than inflation-fighting sends a clear message as well and will likely contribute to an increase in inflation expectations. This carries particular risk at a time of soaring commodity prices.

Accordingly, we continue to recommend that clients maintain inflation as well as deflation protection in the current environment. While inflation hedges (liquid and illiquid hard assets and inflation-linked bonds), like deflation hedges (intermediate- to long-duration Treasuries), are generally expensive today, investors with sufficient exposure should maintain their allocations. For those investors that have inadequate exposure to hard assets, we would recommend gradually building exposures, even if that means taking some price risk today, as the risk of inflation has increased. Investors should begin building allocations to hard assets by selecting those investments that offer the greatest value, at least in relative terms, and offer a reasonably liquid means of providing inflation protection. We are mindful that no great bargains are available at present, but believe that commodities (through a diversified exposure) and oil and gas partnerships (many of which use hedges), to give two examples, are fairly valued. However, it could take years for private oil and gas partnerships to draw down capital and provide distributions given today's price environment. Further, we are concerned about the recent sharp run-up in commodities, and their risk of a significant correction in the short term. We would therefore take a slow, but steady approach to investing in hard assets, taking advantage of weakness to build allocations. Given the soft economic conditions and deflationary pressures, it is likely that hard asset prices will come under pressure, providing better entry points in the future as well as a strong rationale for dollar cost averaging of entry positions.

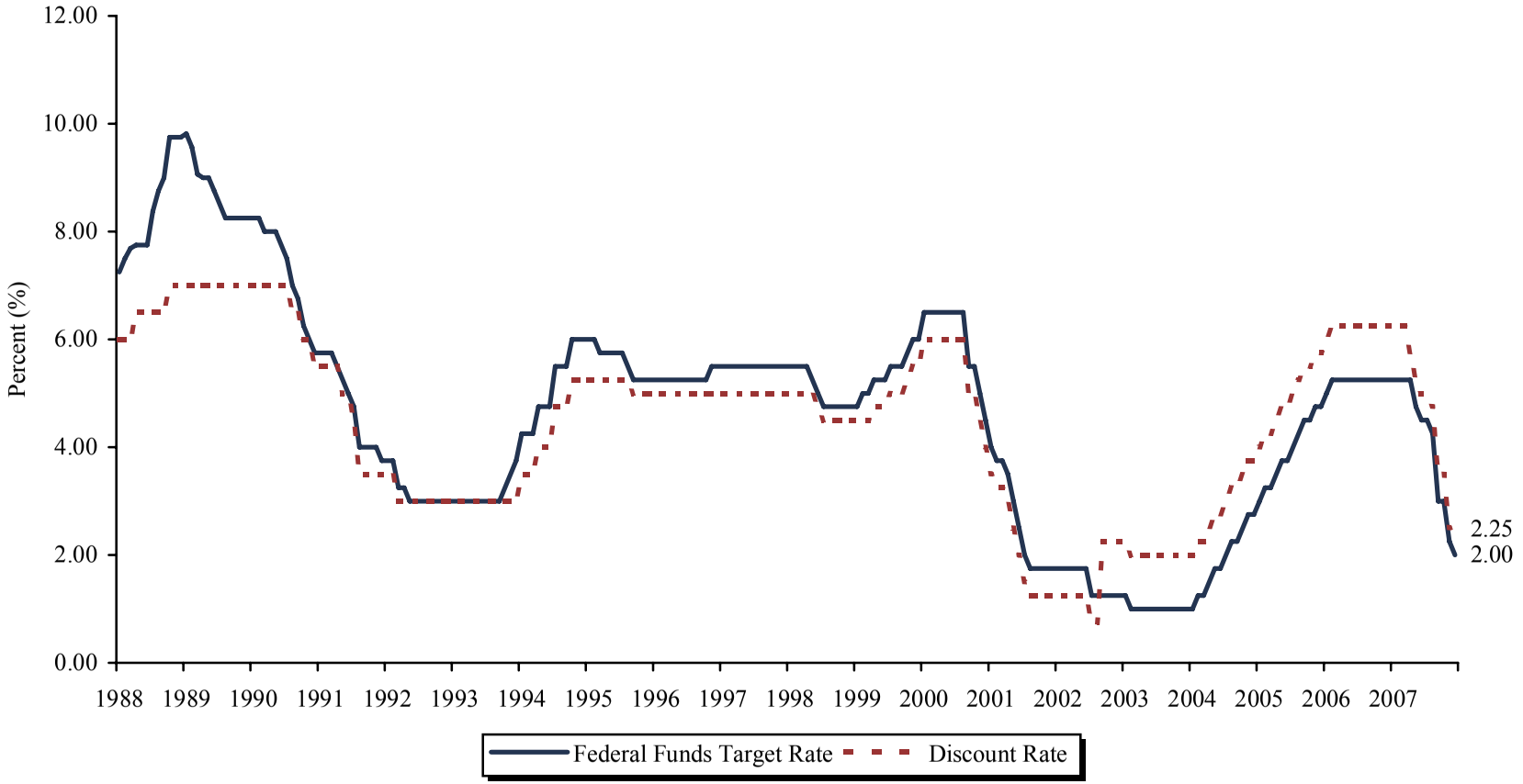
As for the U.S. equity component of a portfolio, meanwhile, the increased inflation risk associated with the Fed's reflation policy also supports our continuing advice that investors focus on mega caps. These firms tend to have a larger international presence, which offers some protection in a weak dollar environment. Finally, because we also believe that the dollar will decline over the long term, particularly against Asian and emerging markets currencies, and because we believe these markets are attractive from a secular perspective, we continue to advocate nonhedged exposure to assets (across asset classes) denominated in nondollar currencies.[19] While we have no view on how the dollar will perform in the short or medium term, we would not be surprised to see it snap back at some point, particularly versus European currencies against which it is undervalued by some measures, given the rapidity with which it has fallen of late. Moreover, investors need to consider the effect of currency on unhedged global portfolios given the period of heightened currency volatility that we believe is in store.

[19] For a more in-depth discussion of our views on asset allocation please see our April 2008 Market Commentary *The Eye of the Storm.*

Table A

U.S. FEDERAL FUNDS TARGET RATE AND DISCOUNT RATE

May 31, 1988 – April 30, 2008

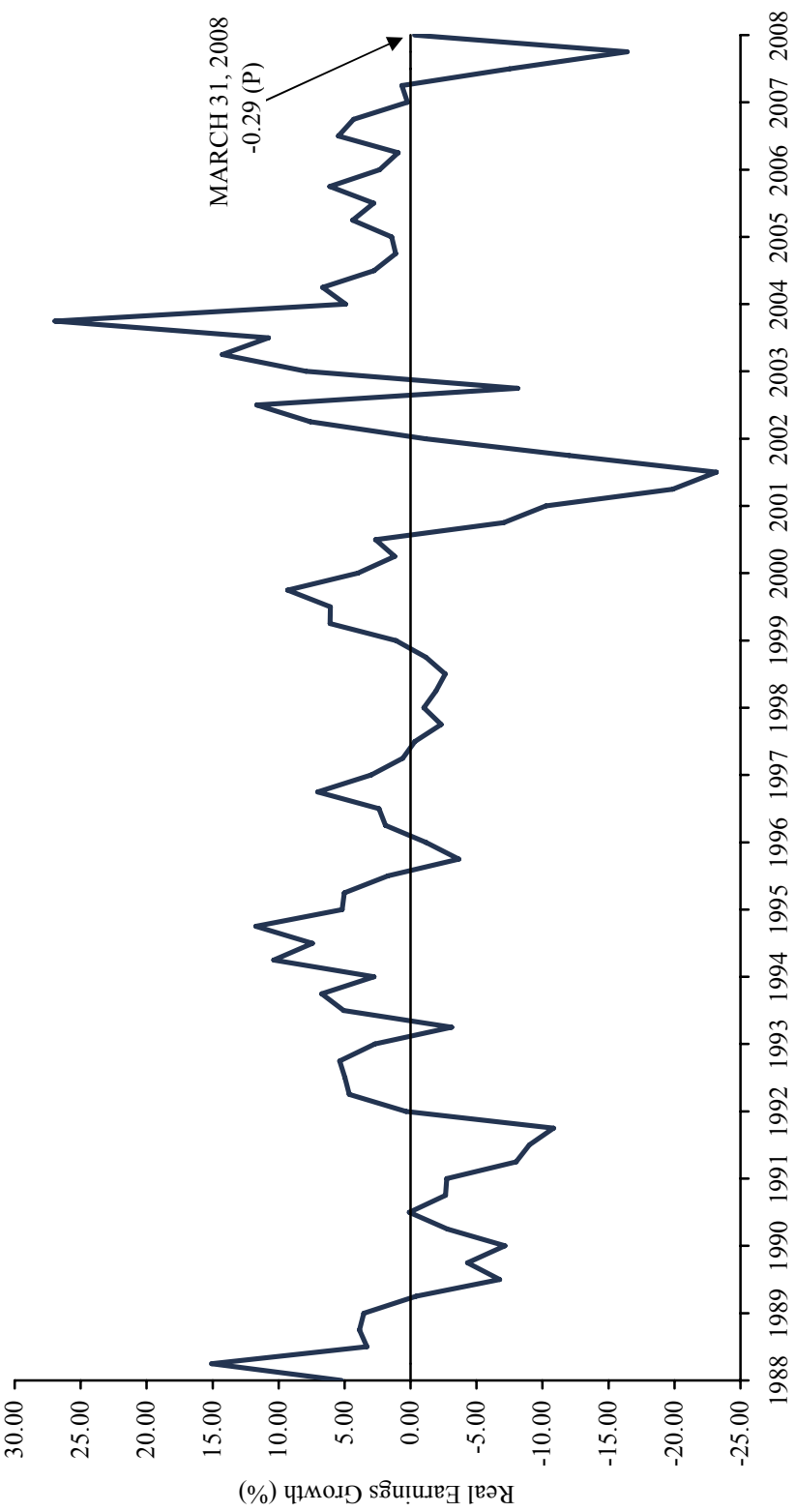


Sources: Global Financial Data and Thomson Datastream.

Notes: The Federal Reserve revised the discount rate on January 9, 2003, introducing two rates. Beginning January 31, 2003, the Primary Credit Rate is used.

Table B

S&P 500 REAL EARNINGS GROWTH SINCE 1988 (QUARTER-OVER-QUARTER)



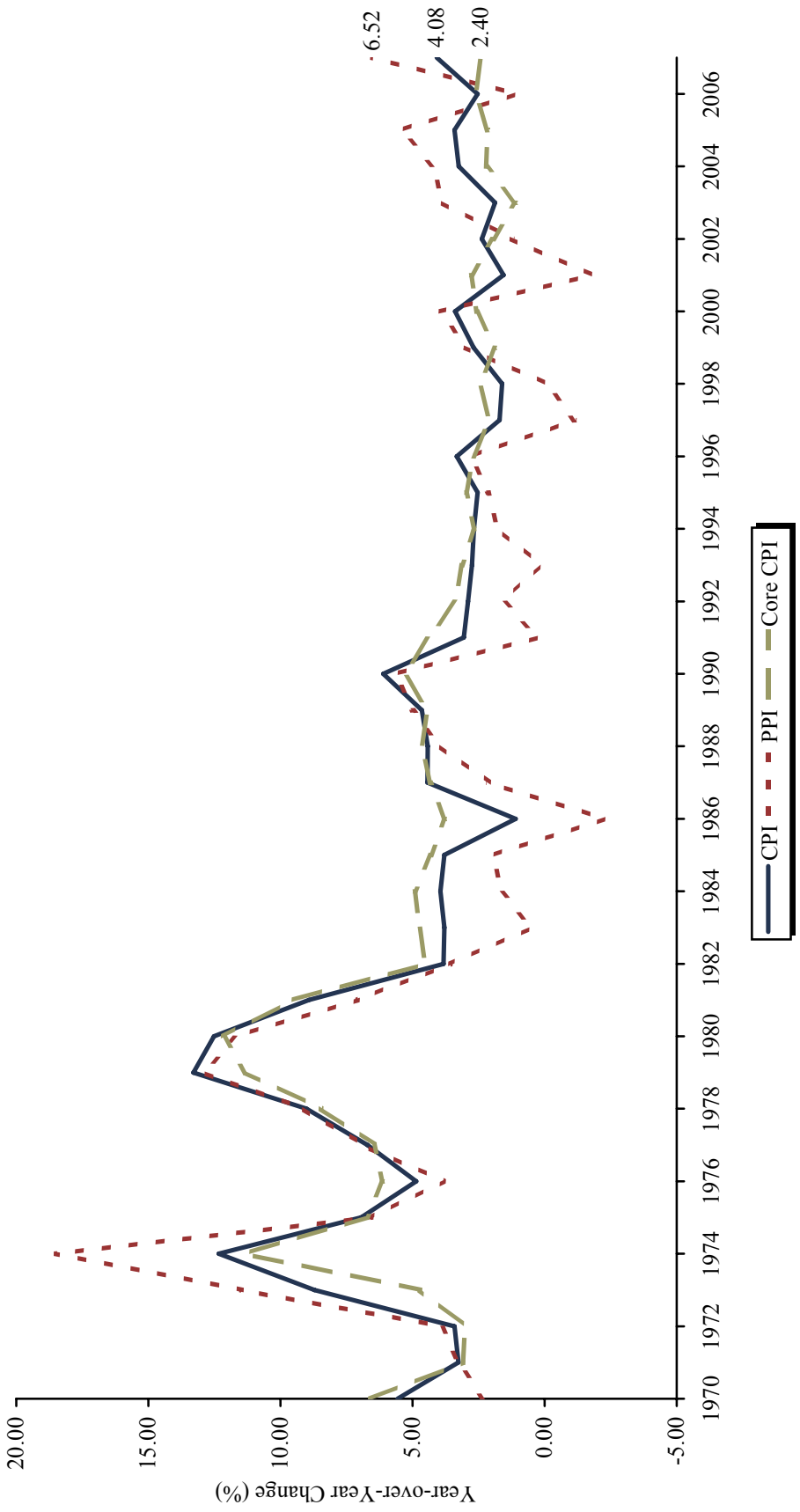
Sources: Calculated from data provided by Standard & Poor's, Standard & Poor's Compustat, U.S. Department of Labor - Bureau of Labor Statistics, and *The Wall Street Journal.*

Notes: (P) Preliminary. Quarterly real earnings growth data are adjusted to March 2008 dollars.

Table C

CPI, CORE CPI AND PPI FOR THE UNITED STATES (YEAR-OVER-YEAR)

1970–2007



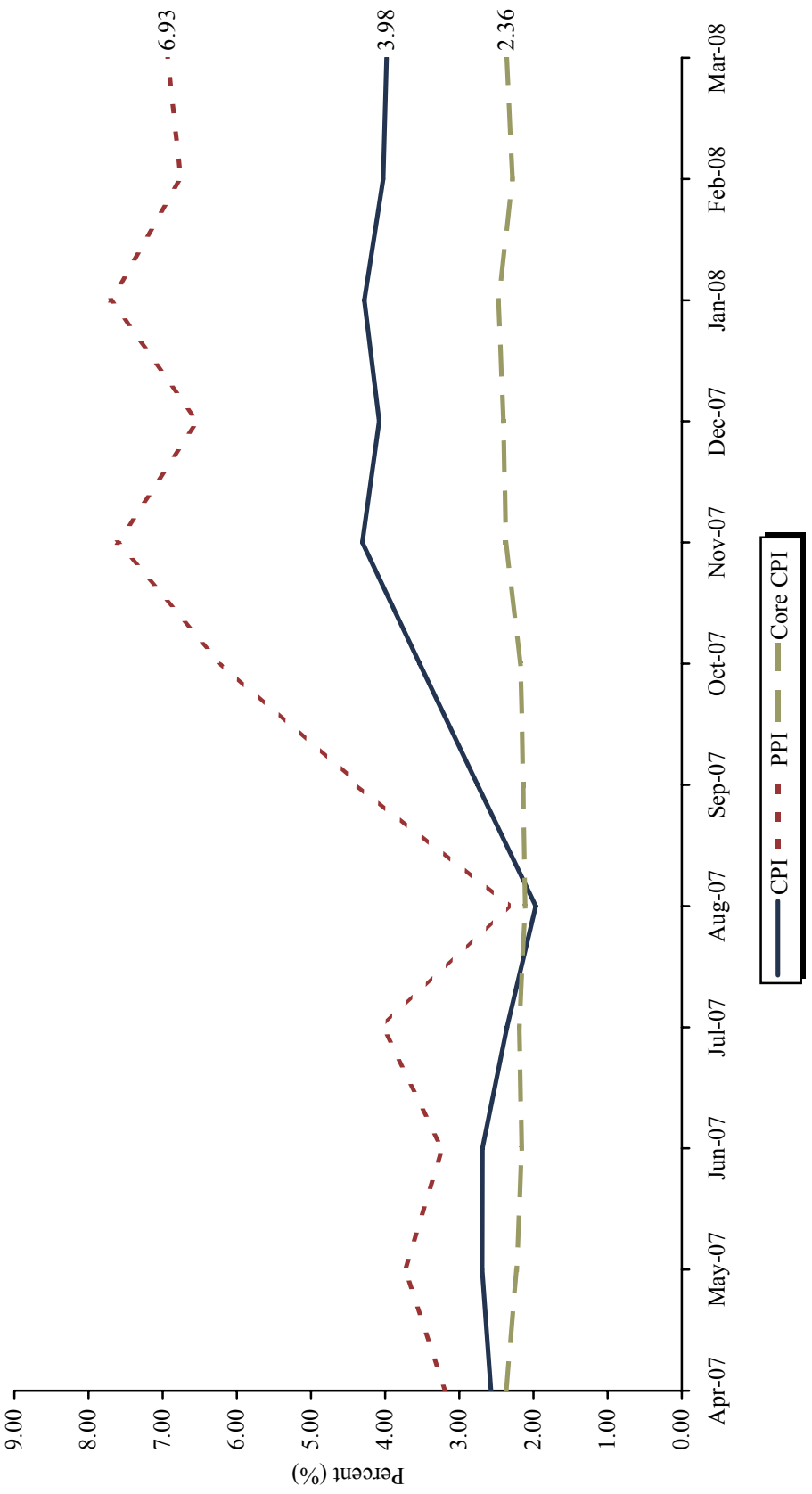
Sources: Thomson Datastream and U.S. Department of Labor - Bureau of Labor Statistics.

Note: PPI represents the Producer Price Index.

Table D

MONTHLY PRICE CHANGES

April 30, 2007 – March 31, 2008



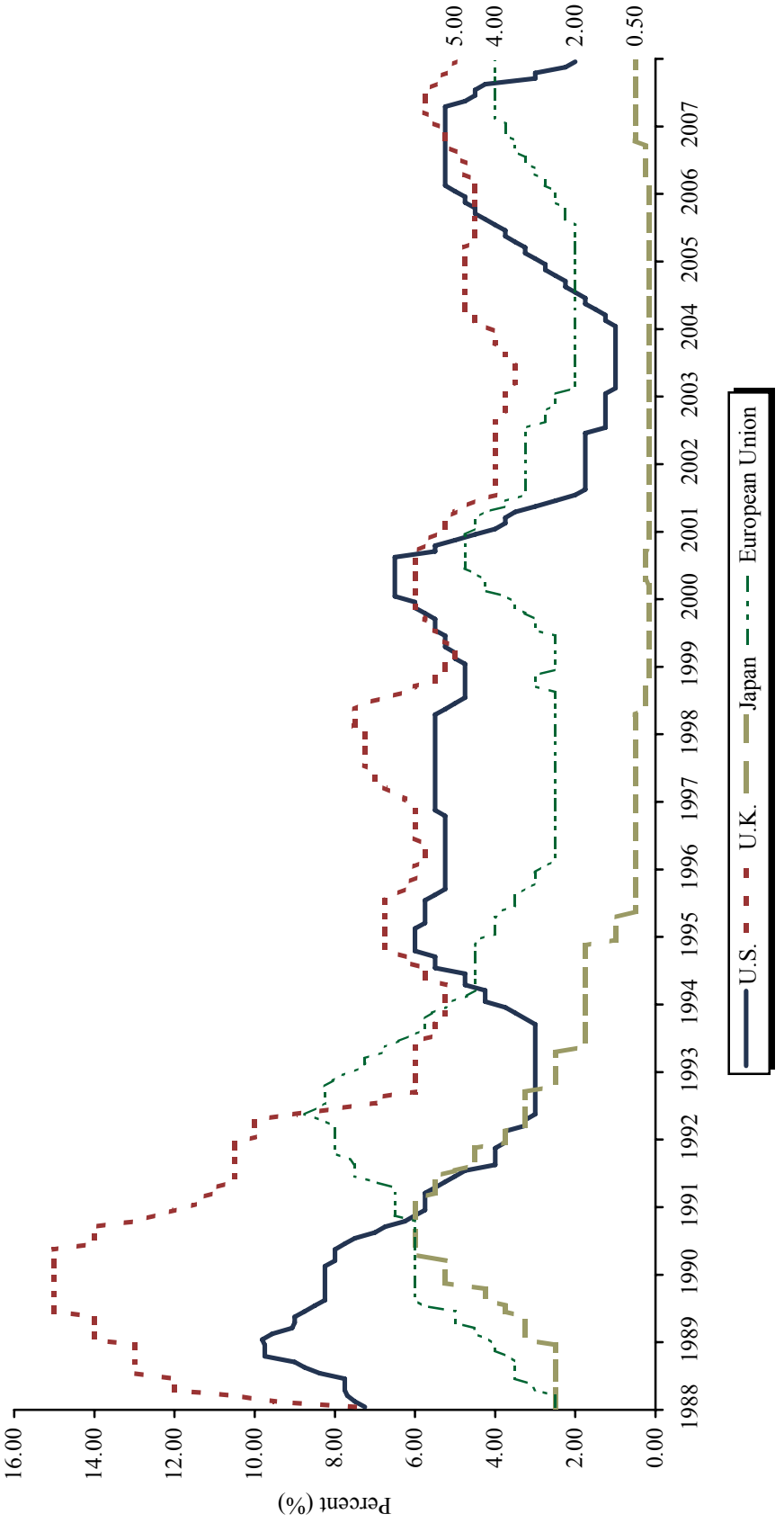
Sources: Thomson Datastream and U.S. Department of Labor - Bureau of Labor Statistics.

Note: PPI represents the Producer Price Index.

Table E

POLICY RATES

May 31, 1988 – April 30, 2008



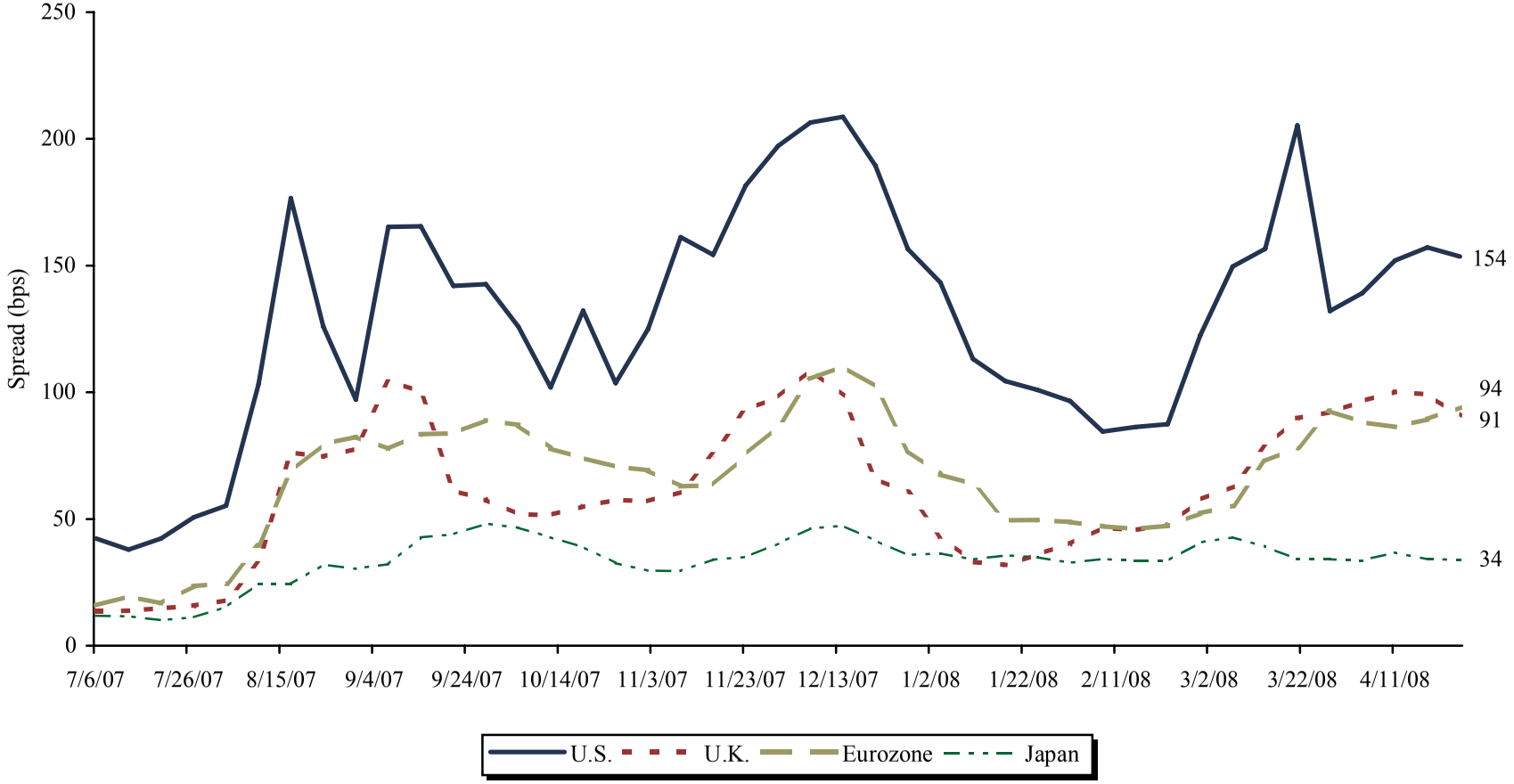
Source: Thomson Datastream.

Notes: Data for the European Union prior to January 2001 are based on German policy rates. All rates measured in local currency.

Table F

TED SPREADS

July 6, 2007 – April 25, 2008



Sources: FactSet Research Systems and Thomson Datastream.

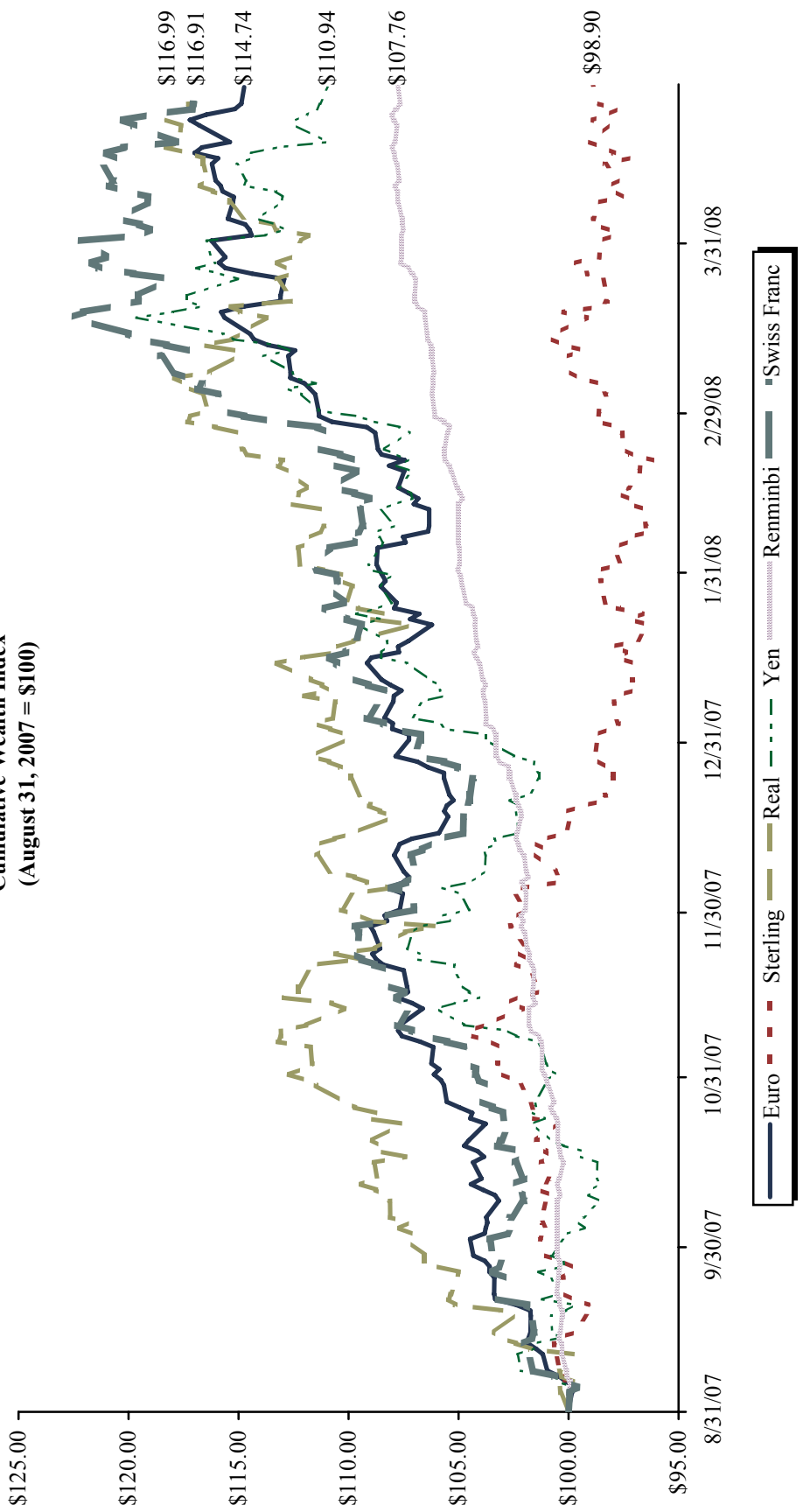
Notes: TED spreads are calculated by subtracting the three-month Treasury bill rate from the three-month LIBOR in local currency terms for each region. All data are weekly through April 25, 2008.

Table G

SELECTED CURRENCIES VERSUS THE U.S. DOLLAR

September 3, 2007 – April 28, 2008

Cumulative Wealth Index
(August 31, 2007 = $100)



Source: Thomson Datastream.