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NO COUNTRY FOR OLD MEN

While never easy, the economic and investment climate is particularly treacherous now. Former Federal Reserve Chairman Alan Greenspan suggests that the situation is more challenging than any he had experienced, and he experienced some major league crisis, like the 1987 equity market crash, the early 1990s S&L crisis, the Mexican devaluation in 1994-1995, the 1997-1998 Asian financial crisis, the Russian default and LTCM failure in 1998, the end of the equity market bubble in 2000, and of course the fallout from the 9/11 attack on the US.

Fro many of the numerous critics of the Federal Reserve, there may be a striking parallel between current Federal Reserve Chairman Benjamin Bernanke and the main protagonist in the latest Coen Brothers ("No Country for Old Men"), the Sheriff Ed Tom Bell who is dedicated to his job, but overwhelmed by developments just beyond his ken.

There is a New Sheriff in Town

Nearly from his first day in office, many people have been doubters of "Helicopter Ben" as he is derisively called for his suggestion of how central banks can counter deflation. Ironically, despite efforts to enhance the transparency of the Fed and to improve its communications, investors are finding the Bernanke Fed less comprehensible than his purposefully opaque and circuitous predecessor. And the large inter-meeting rate cut at the end of January has further obfuscated the Fed's signals.

While there is no doubt the economy has slowed appreciably, the Federal Reserve has acted decisively. Bernanke began cutting interest rates last August and, through the end of last month, had slashed the Fed funds target by 225 bp. This is far more aggressive than any one could have reasonably anticipated and is all the more significant in its contrast to the gradualism that generally characterized the Greenspan era.

Real Real Interest Rates

To appreciate how aggressive the Fed is, consider the level of real interest rates. Real US interest rates are well below zero, which is extraordinarily low for an economic contraction, which if it has begun, has just begun.

Some observers seem intent on deriving real interest rates by adjusting the nominal rate by the deflator of core personal consumption expenditures, but this does not seem fair. Some Federal Reserve officials may cite the core PCE deflator as their preferred inflation measure, but that is for assessing the underlying price trends.

Traditionally, real interest rates are derived from adjusting nominal interest rates by inflation expectations, for which economists often use current headline CPI, on grounds that inflation is auto-correlated, meaning that the best guess for the next period's inflation is the past period. CPI is also more useful for comparative purposes. It is also what the Treasury Inflation Protected Securities (TIPS) use.

There is a significant difference between the two presently. The core PCE measure of inflation stands at an elevated rate of 2.2%. Since the spring of 2004, the core PCE deflator has spent only three months below the Fed's self-declared threshold of 2.0%. Headline consumer prices had risen at a 4.1% year-over-year in December. The US yield curve from Fed funds through the 10-year note yield is well below that.

Shoot-Out

If Bernanke is Sheriff Bell, then some of the Fed's critics, like the Financial Times' Martin Wolf may be Bell's Uncle Ellis. Ellis was a former law man and accuses Bell of vanity for thinking he personally can make a difference. Wolf argued in a recent op-ed piece that Bernanke's "reflation gamble" could backfire and simply lead to higher inflation.

Wolf argues that if the US slowdown reflects supply shocks, like the rise in oil prices, rather than weak demand per se, then the monetary and fiscal stimulus will result in higher inflation which requires an even more painful unwind later.

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Underlying Wolf's argument and many others is a belief that the large US imbalances, which include the large US trade deficit and the abysmally low savings rates, can be addressed by reducing demand and accepting slower growth.

In the narrative often told by the critics, the equity market bubble was a result of the easing of the Greenspan Fed in the late 1990s. The housing market bubble was a result of trying to mitigate the fallout from the ending of the equity market bubble. And now the Bernanke Fed wants to minimize the knock-on effects of the end of the housing market bubble.

Capital Accumulation Engine is Sputtering

The Uncle Ellis's of the world don't get it. Individuals can make a difference. Policy can make a difference. It seems naïve to believe that governments, even those that are not popularly elected, can simply stand by and do nothing in the face of economic woes.

The major headwind on the US economy does not appear to be a supply or a demand shock. Rather the main problem is that the critical engine of capital accumulation locked up. That engine has been securitization. This has been the key to the financial sector's profitability, which accounted for the lion's share of corporate America's earnings for several years. The slump in their earnings is the driving force behind the sharp drop in S&P 500 earnings.

Securitization in some ways is the intersection of the two key channels by which capital is distributed—banks and markets. The whole securitization project has been called into question by the dramatic loses of the asset-backed securities and derivatives such as collateralized debt obligations (CDOs). The problems in this space have effectively shut down important segments of the capital markets and, as the Fed's recent survey of senior loan officers found, banks considerably tightened lending practices.

Lower US rates in themselves will not rebuild confidence in the securitization process. That will require a number of other reforms that increase the transparency processes and various actors, like the rating agencies and insurers. We are struck by some of the parallels of the high yield bond market 20-years ago. That market has evolved from being operated out of one man's desk drawer to a bona fide asset class. It became deeper, more transparent and more liquid.

Lower rates will help make the fall-out easier to cope with and may help limit the duration and magnitude of the sub-par growth. As Reagan and Clinton demonstrated, robust economic growth makes all sorts of problems and disequilibriums easier to cope with.

The Uncle Ellis' are wrong. Policy makers and investors should act to minimize their maximum regret. The maximum regret in this context is a long hard landing and the deflationary forces that are unleashed by the credit crunch. To worry about inflation when the economic house is burning down is like the guy on the way to the guillotine worrying about his hair cut.

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