STEPPING STONES MANAGEMENT, LLC

The Bernanke Fed

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Students at America's elite universities were getting hooked on all sorts of things in the late seventies but not many were using monetary economics to fulfill their exploratory adventures. It was a book, *A Monetary History of the United States* by Milton Friedman and Anna Schwartz that Ben Bernanke said got him hooked. That's the sort of thing that happens to a young boy who is smart enough to skip 1st grade and then gets 1590 on his SATs. Friedman and Schwartz's *Monetary History* took an unorthodox view that the Great Depression was made more severe by flawed policies out of the Federal Reserve. Bernanke made a name for himself delving into that question while becoming a leading scholar on that economic catastrophe. He became enough of an expert to head the economics department at Princeton University as well as the National Bureau of Economic Research, the group that officially dates recessions. In 2002 he became a governor of the Federal Reserve Board. Not well known at that time outside of academic circles, Bernanke gave a series of speeches that fall explaining his monetary philosophies.

The first speech on bubbles expressed skepticism that officials could be expected to identify bubbles before they became destabilizing and even if so, whether they had the proper tools to combat them. Describing the collateral damage that could be inflicted upon financial markets and the broader economy, he said "one might as well try to perform brain surgery with a sledgehammer." His second speech was the keynote at a celebration of Milton Friedman's 90th birthday when he expounded on Friedman's book and the field of study that meant so much to his life. The lesson of his address was the power of monetary policy and how it caused havoc in the Great Depression, so its practitioners should tread carefully. He closed by saying to Friedman and Schwartz, as an official of the Federal Reserve, "you're right, we did it. We're very sorry. But thanks to you, we won't do it again."

Helicopter Ben

It was the third speech on November 21, 2002 that has proven to be the most telling in how the future Chairman of the Federal Reserve would handle the financial crisis that fell on his watch. The topic was deflation, and it was the speech that gave Bernanke his famous nickname. The context was preventing a Japanese style deflation from hitting the US economy. Bernanke said it was extremely unlikely because of the structural stability of the US economy and the existence of the Federal Reserve itself. He said deflation is almost always a result of a collapse in aggregate demand and central bankers have tools to combat that, even when short term rates are already near zero. Since the best way to get out of trouble is to not get into it in the first place, Bernanke said the Fed should maintain a buffer zone for the inflation rate and take most seriously its responsibility to ensure financial stability in the economy.

It is this concept of inflation targeting that will define his contributions to the Fed over the next few years. Bernanke went on to say that rates should be cut aggressively when the economy deteriorates in a low inflation environment. Like any good Freidman disciple, he espoused the monetarist view that inflation could be brought about by increasing the number of US dollars in circulation. However, it was the tools beyond the setting of short term rates that provided the clearest clues to his future consequential chairmanship.

Explaining the term structure of interest rates as an amalgamation of future short term rates, he said the Fed could affect longer term rates by expressing a credible commitment to keep short term rates low for an extended period of time. If the market expects the Fed's Zero Interest Rate Policy (ZIRP) to remain in place for the next year, then one year rates and shorter would tend towards zero too. Even preferable to that he said would be for the Fed to announce explicit ceilings for yields on long term Treasury debt. Interestingly the Fed never used this preferred tool in its historic quantitative easing programs of the last five years, choosing defined dollar amounts of accommodation instead. Playing chicken with the bond market could severely damage the Federal Reserve's credibility if it was found to be unable to maintain such ceilings.

Bernanke mentioned other tools that provided the blueprint for how he would handle the crisis that would hit in 2008, and its aftermath. One was to offer fixed term loans to banks at low or zero interest while accepting a wide range of private assets as collateral. The Fed made that historic move in early 2008 after Bear Stearns collapsed and again that fall amidst the Lehman Brothers and AIG failures.

Another option would be for fiscal authorities to pass a broad based tax cut to stimulate aggregate demand while the Fed implemented a program of open market interventions to alleviate any tendency for the higher deficits to cause interest rates to rise. He said "a money-financed tax cut is essentially equivalent to Milton Friedman's famous 'helicopter drop' of money." Thus was born "Helicopter Ben", the pundits could not have known how applicable the moniker would become. Although Bernanke's quantitative easing since 2008 has not been part of "a money-financed tax cut" the program did finance the unprecedented deficits of recent years in the quest to boost aggregate demand in the US economy.

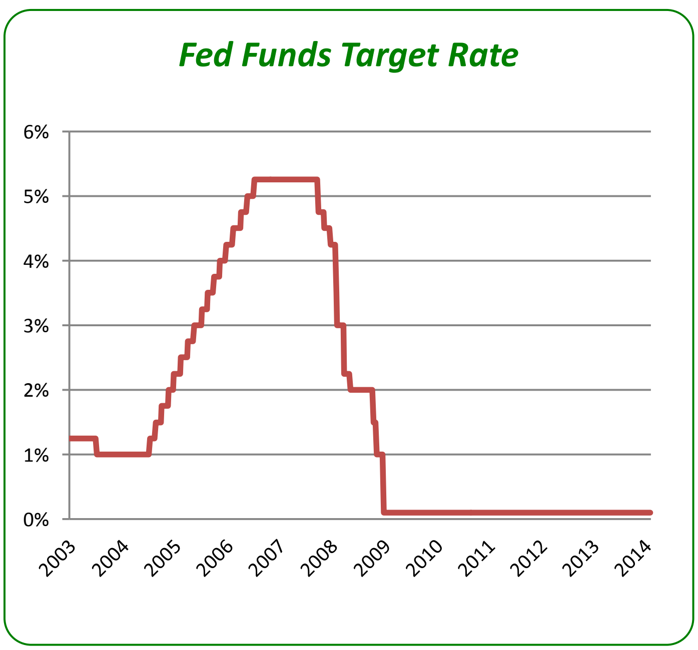
Filling Greenspan's shoes

The deflation speech was given in the wake of the dot com crash, accounting scandals and terrorist attacks as the nation was undertaking an open ended war. Facing such serious issues of that day, the presentation was not as tongue in cheek as Friedman's metaphor might suggest but Bernanke made clear that deflation remained unlikely. More important to him as he joined the Federal Reserve was the concept of inflation targeting and bringing more transparency to the central bank lest our democracy grow suspect of so much power residing with a group of unelected officials. This came in stark contrast to his predecessor who kept markets bewildered by his mysterious rhetoric.

In January 2000 before joining the Fed, Bernanke made the case for inflation targeting in a Wall Street Journal op-ed titled "*What Happens When Greenspan Is Gone?"*. Paying homage to the Maestro, he wrote that it would depersonalize and institutionalize the Greenspan approach. Where Greenspan is a "seat of the pants" economist, Bernanke prefers the academic models that he spent his career developing and refining. He wrote that the transparency of an inflation target would diminish economic uncertainty and have the added benefit of insuring against deflation. Students of the Great Depression never dismiss deflation.

As Chairman, Bernanke furthered transparency with disclosures of the Fed's economic expectations and the quarterly press conferences after Fed meetings. All were meant to give the markets a sense of the board's thinking so that policy can be telegraphed which may alleviate the need to take certain actions. Lately, transparency has become a policy tool with the Fed's forward guidance of interest rates. By stating that short term rates will remain low far into the future, the central bank encourages the market to assist by acting along in its efforts.

In 2004, Bernanke led a Fed study that determined that its new policy of talking more clearly about its interest-rate plans had a sizable impact on bond markets and helped to avert deflation in 2003, when the Fed's overnight rate got as low as 1%. That same study determined that the Fed could also enter the market and buy long term US Treasury securities to drive down long term rates as the Bank of Japan had done the prior year in an effort to weaken the yen. Using another Japanese example, the study concluded that the Fed could aggressively add reserves to the banking system calling such a program "quantitative easing". Such talk excites any Washington DC big spender and George W. Bush named Bernanke to head his council of economic advisors in the spring of 2005 as a steppingstone to an expected Chairmanship of the Federal Reserve which began on February 1, 2006.



New Chairmen of the Fed are thought to want to prove their independence and perhaps make a mark on the institution, so it was hoped that Bernanke would end the gradual rate hikes that Greenspan had begun the year before. He disappointed markets by continuing the committee's gradual increases for the next five months, all the way up to 5.25% where they remained until September 2007. A few weeks before the stock market peak, the Fed aggressively cut the overnight rate to 4.75%. It was clear that a financial storm was brewing.

Crash of 2008

The butterfly wings that triggered this storm was the August failure of two hedge funds that invested in the complex subprime mortgage products that were to become so famous. The funds' sponsor, Bear Stearns, had to assume the assets onto its balance sheet and became insolvent the following St. Patrick's Day. Bear Stearns shareholders were massacred and Bernanke would justifiably point out a month later that "we did not bail out Bear Stearns".

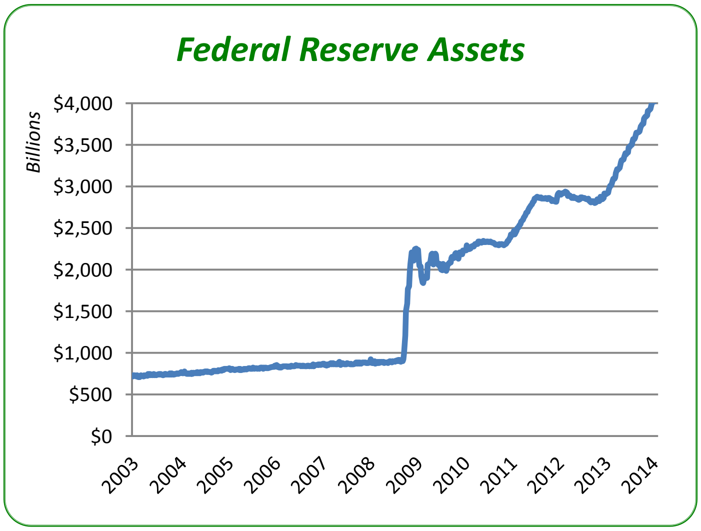
What they did in that case was historic though. It marked the first time the Fed made funds available to companies that were not banks. It also marked the first time the Fed accepted private assets as collateral for loans. The Bear Stearns JP Morgan transaction also saw the Fed assume the risk from certain assets making it a party to the transaction. Bernanke would say later: "we did what we did because we felt it was necessary to preserve the integrity and viability of the American financial system, which in turn is critical for the health of the economy."

Markets cheered for a few weeks and we all know what happened next. In the midst of the panic surrounding the Lehman and AIG failures in September, the Fed intervened further in private markets even coming to the aid of General Electric. By year end, ZIRP had come into place for the overnight Fed funds rate. Many point to the refusal to save Lehman as a seminal mistake but it is unclear what other party would have played the role that JP Morgan played a few months earlier. Perhaps the mistake was the Bear Stearns intervention as it gave confidence to holders of Lehman commercial paper that the Fed would not let it fail. That was the case at the Primary Reserve Fund which broke the buck and set off the worst part of the panic necessitating the Treasury Department to guarantee all money market funds.

Such Monday morning quarterbacking is far easier than navigating in the fog of a crisis, and most would agree that the world was fortunate to have someone with Ben Bernanke's integrity and knowledge at the monetary helm in that crisis. He may have assumed some of his predecessor's rock star status because his efforts to lift the economy out of the severe recession that followed lacked the modestly he had so assiduously promoted earlier in his career.

QE 1, 2, 3…

The Fed rolled out various lending programs with cumbersome acronyms through late 2008 and early 2009. That ballooned its balance sheet far above the $800 billion asset level that had prevailed since Bernanke joined the institution. It wound up the various lending programs in March 2009 when it began what would become the first round of its quantitative easing program by pledging to purchase $300 billion of long term Treasury securities and up to $1.25 trillion of mortgage backed securities. That program ran for a year and then the Fed announced a second round in November 2010 where it would reinvest mortgage bond proceeds and an additional $600 billion into Treasury securities, QE2 would create $40 billion over each of the next fifteen months. Next came Operation Twist where the Fed extended the maturities of its portfolio by selling short term bonds and buying longer term Treasuries in a effort to bring down long term rates. It was announced in September 2011 and then extended the following June. The current round, QE3, was announced on August 31, 2012 and has just begun to taper from its rate of buying $85 billion per month in Treasury and mortgage backed debt. Through it all, the Fed's



balance sheet has grown above $4 trillion in assets as they have succeeded in bringing rates down to historically low levels.

Various Fed governors have said the balance sheet expansion is not inflationary because the added dollars have remained on reserve at the Fed since they began paying interest on reserves in late 2008. Of course by remaining on reserve, the funds are not getting out into the economy as was supposedly intended. Flooding the system with more liquidity has only added to those reserves. When asked why they do not stop paying interest on reserves, Fed governors say that would put pressure on the money market industry which is struggling under the zero interest rate policy. That highlights just one flaw in ZIRP that is constraining the Fed's options.

One outcome of the menagerie of unorthodox monetary policies is that the federal government has been able to borrow unprecedented amounts at unprecedented low rates. The record budget deficits resulting from all the stimulus programs passed by Congress and the White House have been funded with mostly short term debt that has landed on the Fed's balance sheet. Bernanke says this is not a form of monetizing the debt because the central bank is buying the bonds on the open market and not directly from the Treasury. This is a little too cute by half and any objective analysis would conclude that quantitative easing has mostly funded the deficits of the post crash era. Bernanke has scolded the politicians for their budgetary profligacy, but by creating trillions of dollars to buy Treasury bonds, he has been their great enabler.

Financial Repression

Another consequence of Bernanke's unconventional policies has been to skew traditional financial models addressing issues ranging from asset valuation to inflation statistics. Most valuation models will compare the expected returns from an investment to the risk free rate. By pegging that rate at close to zero, every potential investment looks cheap. Manipulating the yield curve has also reduced the ability to discern inflation expectations and other forward looking projections that have historically been a function of market interest rates. Skewing the most important component of most financial models in this way has come to be called financial repression and only time will tell how much capital has been misallocated due to it.

Bernanke has stated that an objective of the Fed's rate manipulation is to drive investment into more risky assets. Large amounts of money have flowed from safe savings accounts that yield nothing into junk bond funds that yield about what a savings account used to. Maybe that will end fine but maybe it will create another crisis when rates reverse and all those old folks want to get out of their junk bond funds at the same time. Bernanke says the higher stock prices following these programs are a desirable outcome as the wealth effect should drive aggregate demand higher.

The higher stock prices combined with zero return on savings have encouraged spending and led to generally healthy retail sales but the overall economic recovery has been weak, even considering the Reinhart and Rogoff slow recovery from crisis thesis. Prior recoveries have seen higher levels of investment than this one, which should not be a surprise when the Fed has disincentivized savings and manipulated market interest rates so low. Investment requires return which the Fed has taken away from the system.

Chairman Bernanke recently reflected on his time at the Federal Reserve proudly pointing to the record low inflation rate during his chairmanship compared to all his predecessors in the institution's 100 year life. He failed to mention that the Consumer Price Index has a 40% weighting to home prices calculated by a formula that is a function of the mortgage rates he has driven down to record levels. Without quantitative easing, mortgage rates would be significantly higher which would translate to higher inflation and lower real economic growth. Due to the Fed's financial repression, we will never really know what inflation and GDP growth would have looked like over the past five years. When rates eventually do normalize, it will have the opposite effect from what Bernanke has recently enjoyed.

As the tapering process has begun, some of those externalities are coming into view. Emerging market finance ministers have been vocal about their displeasure with Fed policy, and Bernanke has been dismissive of their complaints citing his concern with the US economy. When QE3 launched in late 2012 sending waves of hot money flooding into emerging markets, Bernanke told an IMF gathering that the emerging market countries should embrace their strengthening currencies. As those waves reverse they could disrupt the US financial stability that he says is so important. As smart as anyone may be, recent history proves that the finest minds can all miss a black swan.

Bernanke famously told 60 Minutes in December 2010 that he was 100% confident that he could raise rates in 15 minutes if he had to. He never had to prove those words but Chairman Yellen will be tasked with the great unwind. The Bernanke transparency policies may make her job easier than prior tightening cycles or maybe not. The jury will be out on these extraordinary years of monetary history at least until that full cycle has been completed. After it has, scholars following in Ben Bernanke's footsteps will study how effective the Japanese policies were for the US economy. We can only hope they work better here. If not, the philosophies of Dr. Bernanke, where the blunt sledgehammer of monetary policy should be used with great care, may carry more weight than the aggressive policies of Chairman Bernanke.

Daniel D. Hickey
STEPPING STONES MANAGEMENT, LLC
PO Box 263
City Island, NY 10464
direct: 646-723-6262
www.steppingstonesmanagement.com