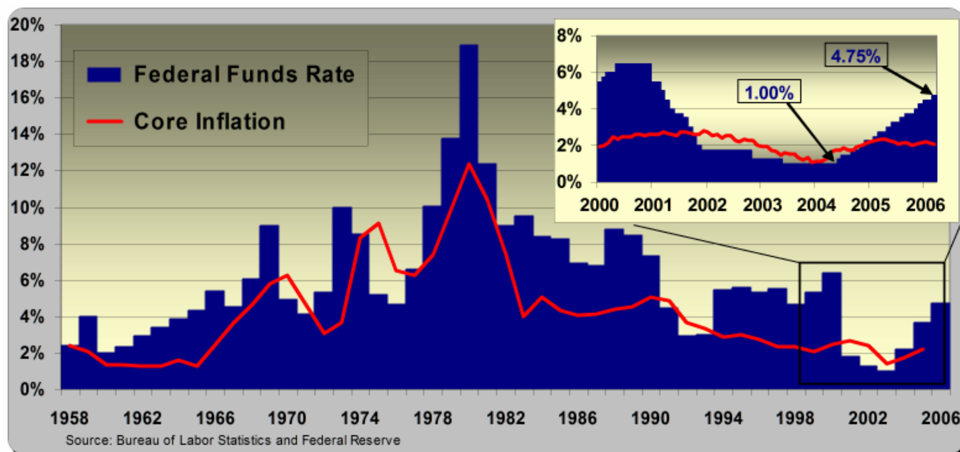
Investment Watch

1st Quarter, 2006

"No More Cheap Money!"



Ben S. Bernanke (ber-NAN-kee), the newly minted Federal Reserve Chairman, snatched the baton from Alan Greenspan, and matching him stride-for-stride in the **inflation** marathon, raised the Federal Funds rate last week another quarter of a point for the 15th straight time from 1.0% to the current 4.75%, and echoed the Fed's collective voice, *"No More Cheap Money!"*

How did money get so cheap in the first place? Remember the end of 2000 when our economy was falling behind, the Fed **lowered** rates from 6.5% down to the rock-bottom rate of 1.0% not seen in 50 years! They reasoned that emergency easing was required to avoid a prolonged recession and ease the pain after the tech bubble burst. We raced with this **cheap money** for four years. We borrowed more and spent more. Money wasn't cheap only here, it was cheap all over the world, but most of the world's economies were stuck in the starting blocks!

All three major central banks - our Federal Reserve, the European Central Bank and the Bank of Japan - provided abundant liquidity and almost free cash because the world's economy had slowed to a snail's pace. In particular, the Bank of Japan in March 2001 began emergency "quantitative easing" and flooded Japan's money markets with liquidity - an all out sprint to avoid *deflation*. The European Central Bank chimed in lowering its refinancing rate to 2%.

The race was on... The US dashed into the lead reacting quickly to the stimulus pulling out of recession in early November of 2001, but the rest of the world would be slow to follow. Back here at home, even though we were experiencing rapid economic growth, it was a jobless recovery. So Greenspan's Fed kept the **cheap money** flowing with low Fed rates. This allowed for faster growth and for the US consumer to borrow more and continue to spend - leading the world economy out of recession.

Many developing markets across the globe including Eastern Europe, Asia, Brazil and Mexico have joined the US in the lead pack. Over the past year the European Union and Japanese economies have finally gained momentum while their consumer and business confidence appears to be mounting. Even though the developing countries are running fast, their small size limits their impact. We need just a slight increase in the pace of the mammoth European and Japanese economies to provide a substantial boost to global growth.

This brings us back to today, no more **cheap money** here at home and no more **cheap money** in Europe or Japan, well maybe at least in the future. As we already know our Federal Reserve has tightened rates from 1.0% to 4.75%, while the European Central Bank has only begun tightening by raising its refinancing rate from 2.0% to just 2.5%.

What's more, the Bank of Japan this month finally ended its five year deflation-fighting policy of holding interest rates near zero percent. Even though they haven't actually raised rates yet, this at least sets the stage for future rate hikes in the world's second-biggest economy.

Before these other central banks close in on our lead, let's take a closer look at the legacy our new Chairman Bernanke inherits and try to peer into the future to see if he's a good marathoner.

The gold standard was expected to guarantee price stability. After it collapsed in 1973, the US consumer was in for a wild economic race. By the time Paul Volcker became Federal Reserve Chairman in 1979, inflation was rampant. Without delay on October 6, 1979 the Federal Reserve announced it would control money growth and aggressively fight stagflation, high inflation matched with unemployment and recession—the proverbial *"Brick Wall"* for marathon runners.

The Fed's actions were swift and harsh, resulting in the worst recession and unemployment since the Great Depression. But as can be seen from the graph above, inflation was conquered by 1983 and has remained in check ever since.

If inflation has been held in check for over 20 years, why is the Fed still concerned? The Federal Reserve Act mandates that *"the Federal Reserve System ... promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."* We're in a marathon race vying for long-term growth with low inflation. It's a race in which pace is the key to victory. If growth is too fast, inflation reemerges. If money's too tight, growth is slow.

The Federal Reserve opened the Bernanke era the same way it closed Alan Greenspan's with a rate hike, but there are differences.

The press on Bernanke heralded a new "more transparent" Fed. But, in his début speech to the erudite Economic Club of New York, he was able to top his predecessor's normal level of confusion, dubbed *"Greenspeak"* when rationalizing the continuing conundrum of low long-term interest rates in the face of the Fed tightening.

Bernanke argued that Fed rates may have to be higher if this interest rate conundrum stemmed from a "decline in term premiums" or lower if caused by the "global savings glut". Basically, he said that the Fed rates could either be higher or lower! All the Bulls want lower rates so as not to hold the economy back. They want to sprint. The Fed wants to slow the pace. Bernanke and the Fed know that if you run too fast at the start of the race, you can fade at the end.

Many pundits believe that the Fed has already gone too far, sighting low long-term rates. They also feel the Fed overshoots during tightening causing slow growth. Bernanke advocates a clear "inflation target" of 1% to 2%. Currently we're at the upper bound of his target. Last week in the Fed's first policy statement edited under Bernanke's tutelage the Fed's tough talk about inflationary pressures has bolstered the prospect of more future rate increases.

Our economy is running strong. We have the training and stamina to survive $65 oil with nary a stumble. The Fed's mandates mirror our goals. They feel higher rates will protect us against inflation. So *"Don't fight the Fed."* The Fed believes we can win the inflation marathon with a steady, even pace achieving sustainable economic growth right to the finish line—even without **Cheap Money!**

March 31, 2006

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