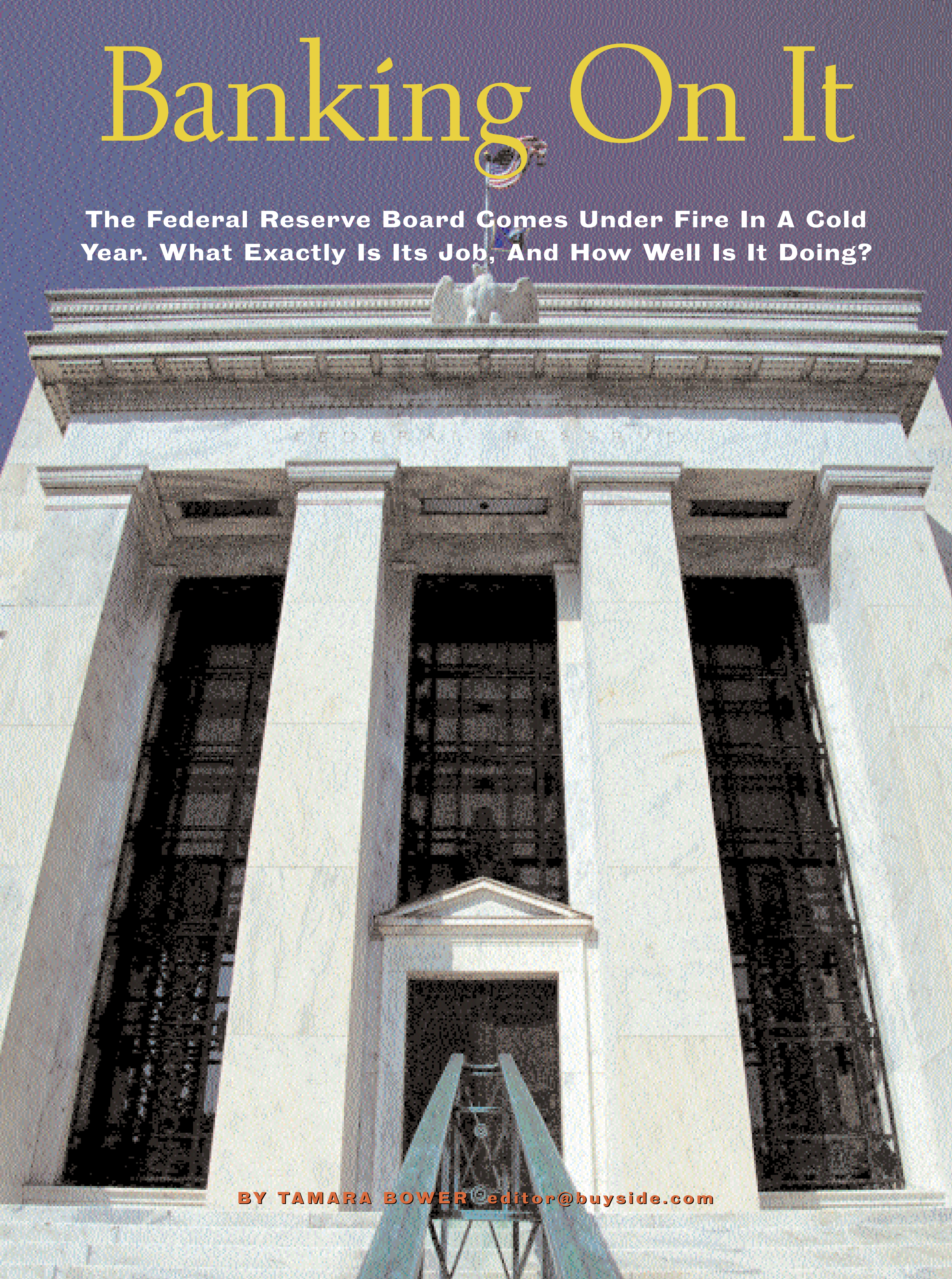
Banking On It

The Federal Reserve Board Comes Under Fire In A Cold Year. What Exactly Is Its Job, And How Well Is It Doing?



BY TAMARA BOWER editor@buyside.com

It has been a year of many issues swirling in the markets: recovery or recession, economically and in stocks; sector rotation, as investors sought the newest safe havens; and the U.S. being dragged into war through terrorism. As the year has progressed, buffeted by events, all eyes have been on Federal Reserve Chairman Alan Greenspan. Indeed, much discussion — and virtually all economic and market forecasts — have hinged on the role of the Federal Reserve Board and monetary policy, and its impact on the markets.

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— Margaret J. "Peggy" Preston, Investment Counselor, Carret & Co.

Buyside conducted a panel discussion with audience participants in New York to give an understanding of the complex machinations of the Fed, and to offer readers a compass for navigating the coming quarters. Panel members included Margaret J. "Peggy" Preston, investment counselor with Carret & Co.; Kenneth W.P. Hoffman, CFA, director of alternative investments for Orbitex Management; Josh Feinman, chief economist and managing director of Deutsche Asset Management; and Terri Spath, vice president and portfolio manager of the Franklin Large Cap Growth Fund.

As *Buyside's* editor, I filled the role of moderator. When the question-and-answer portion concluded, the audience — including Keith Rabin of KWR International, Vincent Benedetti of Gruntal & Co., John Stone of Ladenburg Thalmann and others — was invited to participate with questions or comments.

Buyside: The Federal Reserve Board's stated purpose is to manage inflation and the supply of money, specifically to promote the goals of maximum employment, stable prices, and moderate long-term interest rates, most notably through stabilizing prices. But the Fed clearly extends beyond this Herculean task. Seeking to maintain and stimulate economic growth is reiterated in the minutes of the April 11 and April 18 meetings. Taking this into account, along with the Fed's activity directing seven interest rate cuts in 2001, each meant to contribute to a turnaround in the markets, as well as the economy, why hasn't it fallen into place?

Peggy Preston: "I'm sure if you had asked Alan Greenspan a year ago what seven interest rate cuts would have done for the economy, he would probably have been reluctant to give you an answer of the boom he might have expected. The actions of the Federal Reserve — it is an art; it is definitely not a science. Many of the responses that were expected to happen with all of these rate cuts really did not occur initially this time around.

"The prime example would be that long-term interest rates did not really respond as expected with the initial rate cuts by the Fed. They can influence short-term rates, but we saw the yield curve steepen, and it seemed to indicate that perhaps the bond market was still very worried about inflation. I think Alan Greenspan was a little surprised by the reaction of long rates, as I think he was surprised by the continued strength of the dollar. The normal reaction would have been a weakening of the dollar, which would help our economy by increasing revenues and exports.

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"The 1990s were a wonderful time period in our economy, because we had tremendous capital investment going on. Unfortunately by the late 1990s, through tremendous spending, we got into an overcapacity situation. Cutting interest rates is not going to remedy that situation in the short term. We have to be able to work through this overcapacity situation, and that's why Greenspan keeps reiterating to people, 'It will take time for the economy to completely work through this investment overlay cycle.' "

Ken Hoffman: "There are so many moving parts the Fed is trying to control. I run a multi-industry hedge fund, so I get to look at all different parts of the economy, and how they all work together. And it's very interesting — the Fed is cutting rates like mad at the same time when home sales are at an all-time record high. Usually when you cut interest rates, you're trying to spur home sale growth, and that's probably why home sales have stayed so high.

"Car sales were at all-time high record levels, and they stayed [high] so long. So I think people looking at the market are saying, "What is the Fed really trying to do?" And I think Greenspan really got himself into a [no-win scenario] in this entire situation. He can't help out the dot-coms, because they were all financed by equity. Lowering interest rates doesn't help them out, so they continue to go kaput. Massive overcapacity was spent on the telecom and the technology level, and a lot of that was not financed until very recently. It was all equity, which went kaput. There was nothing he could do about it.

"And even though [the Federal Reserve Board] said they didn't care about the stock market, obviously the stock market, which has lost roughly $7 trillion, means a lot to everyone else. So, what scares me going forward is that the Fed has used many bullets in its gun. Some analysts are now saying that both car and home sales may decline sequentially for the rest of the year. And what we're hearing about mid-month August sales is they continue to drop off. I would think the refinancing boom is probably going to end fairly soon. Year-over-year rates have come down substantially. So that's a problem. And now the dollar, which Peggy said probably should have weakened a long time ago, is starting to weaken, and weaken aggressively.

"One of Europe's biggest costs is energy. Since energy is priced in dollars, the stronger euro means lower energy costs. In the last several weeks, the price of energy in Europe has dropped by 10% even though the overall price of oil has stayed constant, since the Europeans are buying all their oil with dollars. If this trend continues, and we see another five or 10% depreciation of the dollar, then all of a sudden, one of Europe's biggest costs will decline by 20%. 'Well, if that's the case, maybe Europe's economy won't be so bad,' investors will say, because they're seeing one of their major cost factors decline. And then maybe you see this spinning out of control where people keep thinking that maybe Europe looks better than the U.S., so the dollar declines and European energy prices drop.

"And we still have a massive trade deficit in the U.S. And the U.S. has cut interest rates, and yet you see housing and car sales. It's a very glum picture, especially from an equity investor standpoint, because many stocks — especially if you look at technology and other issues — their valuations are still two to three times what they were back in the 1990, 1991 timeframe. So, it's very difficult to sit here with a rosy outlook on things when you see all these negative factors lined up. In our hedge fund, we're still short, because we still see a lot of problems that can go forward, and I don't see how the Fed can fix the entire economy on their own. I think you've had the 10-year boom. A 10-year boom is not going to be corrected by a one-year recession."

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Josh Feinman: " These are very good comments. It's that we're not that far into an easing cycle. We need to keep in mind that under normal circumstances, Fed easing takes time. And it is at least encouraging that we are starting to see maybe some nascent signs of bottoming in some areas. It's very mixed, admittedly.

"But I really don't think you would have expected to see the economy doing a whole lot better just from the thrust of easing monetary policy already. I think that's still somewhat premature. The Fed's easing in 2001 might be expected to get the economy doing somewhat better in 2002, but not necessarily right away. And as the other panel members pointed out, I think the economy does have a lot of headwind, if you will, from the excesses and the imbalances that were built up in the late 1990s. And that will continue to make it tougher for the economy to do better, even with easier fiscal and monetary policy."

Buyside: Given the sheer volume of factors that play into this on a global scale, as we've touched on already, balanced by the limited arrows in the Feds' quiver of interest rate and monetary supply manipulation, is it possible for the Fed to better accomplish its task?

Josh Feinman: "Well, the monetary policy works in one way. You can affect the cost of money, the availability of money, the supply of money, the liquidity, and that's what they've done. You could argue they could do it more aggressively perhaps, but that would still be more of the same. More of a quantitative issue, rather than qualitative. There's not a lot more the Fed can do.

"I think they've been moving pretty aggressively. I think the speed and the volume of easing has been quite substantial, and I think it has also been unusual to get a fiscal policy response so quickly and so synchronous with the monetary policy response. I think we've been extremely fortunate in having the ability to have that kind of response and the reaction from the policymakers, because I think very few people would disagree that had we not had such a policy response on the monetary and fiscal fund, the economy would be in considerably worse condition.

"As I said earlier, I think you can make a case that there were tremendous excesses and imbalances that were created in the economy in the late 1990s. We're in the process of having to work those off — the investment overhang, savings problems in the household sector, the current account situation, etc. And of course equity valuations, which were central to all of those. We're in the process of working those off.

"That process is not necessarily going to be pretty. It's going to involve cutbacks in spending and investment — households, firms, everybody tightening their belts. We're extremely fortunate that we had this policy response, which is sort of helping to cushion the blow. Mitigating the deleterious effects on the economy from what they otherwise would be. That doesn't obviate the need for the adjustment, but it at least mitigates its impact.

Terri Spath: "I would echo some of Josh's comments. I think we are very short-term [focused] and myopic and wish that the Feds' moves would help stock prices more than they have. It's pretty unusual for there to be this much Fed easing and for stocks to be this unresponsive to that. And I think that's been needed, because of the strong dollar as well as the fact that interest rates and mortgages were already fairly low.

"It's interesting to me, because a year ago at this time, people were so concerned about excessive consumer demands and strong stock prices. I think basically what the Fed has done is achieved the soft landing that we wanted them to achieve. It's a small price to pay if we just have a quarter or two of weakened GDP growth to pay for our seven years of strong economic growth with no inflation. I do think it's a small price to pay, and I don't think it's going to last much longer than a couple of quarters."

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— Josh Feinman, Chief Economist and Managing Director, Deutsche Asset Management

Buyside: Should the Federal Reserve Board focus on certain criterion over others in their actions? How do you feel about the current focus?

Terri Spath: "The current focus being I think on containing pricing and inflation. I think the entire health and stability of the economy is based on a stable pricing environment. Inflation can be terribly de-stabilizing as we've seen from countries in Latin America, for example, where it's really been a problem. Financial systems crack under severe inflation because it distorts so many different decisions in terms of how companies invest and how consumers react. Whole industries are affected.

"And I think, longer-term, investment productivity does better in a low inflationary environment, because you can make decisions that aren't based on the fact that prices might be going up very dramatically. So, I think that the focus on the pricing environment as a core focus has been very stabilizing."

Ken Hoffman: "I think one of the things that the Fed needs to look at also is — and I don't know how they do this — but if you look at banks, there's plenty of liquidity at the banks. And yet banks still are not lending as much as one would expect. And when you talk to lending officers, they say, "Well, yes, there's a lot of liquidity. The Fed is not errant on that." But I'm looking at loan loss reserves, particularly in the commercial real estate market, and they are rising at a staggering rate as the telecoms and dot-coms all go out of business. And that's starting to creep over into the consumer part of the business. And I remember back in 1990 and 1991 how this went.

"So [as a banker] I don't want to be out there lending like crazy, and then all of a sudden have all these big losses that I have to take. When you talk to the banking analysts, they're saying the bigger banks are very, very scared — probably at the wrong time, but that's the way they are — and the Fed needs to turn that situation around to get the banks comfortable that they should start lending, because once they start lending, that gets the ball rolling on the economy. At this point, however, it's still scary, because you still see all these lay-offs and everything going on. It feeds upon itself, and the Fed needs to turn that scenario around."

Buyside: Should the Federal Reserve Board seek to be more or less benign in its reach?

Peggy Preston: "The Federal Reserve is an appointed organization, and is supposed to maintain essentially a neutral stance. They have their guidelines of trying to maintain an environment for sound economic growth. And that is really their mandate. The Fed does not want to be accused of partisanship or favoring certain industries or certain sectors. The Fed has taken a lot of criticism in the past.

"There was one point in the late 1990s when the Fed was accused of easing to save everyone's profits on Wall Street. I think that was associated with the Long Term Capital debacle. There has been lots of criticism thrown at the Fed. I truly think they have tried to stay in a relatively neutral position, knowing that they are appointed. They don't really want to be tied with one political party or the other. They simply want to follow these guidelines of trying to keep the economy growing without favoring dot-coms or technology.

"There's only so much you can do. When you get into a complete overcapacity situation, you have to wring it out of the economy. Japan hasn't done that. They have tried to take a different tack, hoping that somehow it's just going to go away. And we've seen what's happened there. They're maybe going into their fourth recession. There are some things that have to be allowed to occur.

Buyside: What further measures do you expect or suggest?

Josh Feinman: "I think they'll just need to keep focusing on their long-run objectives — doing the best they can to keep inflation low, which is the most a monetary policy can do over the long haul to help the economy achieve its maximum sustainable growth rate. And in the shorter run, do the best they can to try to mitigate the cyclical behavior of the economy, to try to damp the cycle to some extent.

"Obviously they're not going to be able to preclude the cycle completely, but to try to damp it, to try to perceive if there are excesses or imbalances developing, and try to lean against those. I think they did try to do that in 1999 and 2000 by trying to tighten up a little bit when it appeared that the economy was in danger of overheating. The imbalances associated with the equity market and so forth seemed to be feeding into excessive and unsustainable rates of spending and investment, and the economy living beyond its means. So, they tried to lean against that. I think they were successful in bringing the economy down from those unsustainable rates. Perhaps a little bit more successful than they had anticipated.

"To the extent that the Fed is providing liquidity, which is used to buy stocks at inflated prices, I think that's a problem that the Fed should pay attention to. A lot of the liquidity that the Fed provided in the late 1990s, particularly in 1999, contributed to a move up in the stock prices, and allowed investors to essentially buy these inflated assets at prices that were too high. It's very important to have an independent Fed -- the perception and the actual independence of the Fed adds a lot to the credibility of our monetary system."

— Terri Spath, Vice President and Portfolio Manager, Franklin Large Cap Growth Fund

"Maybe the economy did stumble a little bit more than the Fed would have liked, but broadly speaking, they thought it was prudent for demand to cool off, and it did. Maybe a little bit more. So, they now have been leaning against the downside risks this year. But I think when all is said and done, I would certainly concur that if the economy goes through even a year or two of sub-par growth — what we've seen during the last four or five quarters, but even if that lasts another few quarters — that would still by historical standards qualify as a reasonably soft landing. Given the extent of the boom and the magnitude of some of the excesses and imbalances that developed, that would still be a fairly neat trick to bring this thing in with only a few bumps. The history books, I think, would still say that that was a soft-ish kind of landing."

Buyside: Ken mentioned the estimated $7 trillion in the markets that disappeared with the tech bubble bursting. At the time, interest rates were high, and so was the market. Then the market crashed, but interest rates held, costing already struggling businesses dearly, and discouraging them, as Josh mentioned, from seeking funds through banks to bolster business. What does this suggest about the correlation between the markets and the Federal Reserve Board's ability to react to them, let alone anticipate them? Is that really their job? Should the Fed take a more active approach in trying to anticipate the markets?

Ken Hoffman: "I think they're trying to do that now, which scares me, because I think Federal Reserve policy takes a long period of time. And we like to turn on the television and see exactly what our stocks are worth from minute to minute, and that might switch from day to day. My biggest fear is that the Fed is overreacting to the market. And I think the single biggest worry for the Fed right now should be currency stabilization. I do think this dollar move is starting to get frightening. Obviously the Bush administration is a lot more lenient on seeing the dollar soften than the Clinton administration was.

"They come out publicly and say, "We want a strong dollar," but I think the feel of the market is they would not mind at all, and I think business is telling them that the weaker dollar helps us out. Maybe that's fine over a long period of time, but if it happens dramatically like it's been recently, that could be a problem moving on. I really hope the Fed continues what it has been doing in the past, ignoring what the market is telling us on a very short-term basis, and seeing the long term — where things should need to go. They should say, 'Look, this is the way it should be, long term. Here's how' — nice, smooth, steady, and let the market trade all around it."

Terry Spath: "To the extent that the Fed is providing liquidity, which is used to buy stocks at inflated prices, I think that's a problem that the Fed should pay attention to. A lot of the liquidity that the Fed provided in the late 1990s, particularly in 1999, contributed to a move up in the stock prices, and allowed investors to essentially buy these inflated assets at prices that were too high.

"It's very important to have an independent Fed — the perception and the actual independence of the Fed adds a lot to the credibility of our monetary system. It does take some time for these things to start to show some benefit to the economy. And I think that they've been muted to some extent by the stronger dollar. Typically, if an economy lowers interest rates, it's going to weaken the currency, because the interest rate isn't as attractive as it might be in a local economy. But I think what's changed a lot is that the growth of the U.S. versus the rest of the world has propped that dollar up. So, I think we can afford a little bit of a weakening in the dollar. If anything, it might help us pull things out a little bit more.

"In terms of businesses, the fact that interest rates are low hasn't forced companies to spend money, and that's been a concern also, but there was a stat in *The Wall Street Journal* on August, 20 that showed the amount of fixed income that's been issued in the first seven months of this year — $195 billion in bonds — has already surpassed that of 1998. Who cares? Well, 1998 was the biggest year of issuance of debt ever— $153 billion. So, the fact that we've already passed that number in seven months shows that a lot of businesses might not be spending, but they're taking advantage of the fact that interest rates are so low. It's given them a lot more flexibility in their balance sheet and in their ability to manage their earnings. So we don't want the Fed to be focused on the stock market.

"We do want them to be focused on the health of the economy. It is going to take a little bit of time. And I do think we'll start to see that play through pretty soon."

The floor was opened for comments or questions from the audience. John Stone of Landenburg Thalmann brought up discussion of the yield curve and the Fed's influence on the cost of capital. Gruntal's Vincent Benedetti directed the discussion toward real estate and investment activity fleeing the markets in that direction. Keith Rabin of KWR International raised the question of the impact globally on offshore markets that have thrived on the strong U.S. dollar to maintain their export business. Also, an independent investment advisor with a hedge fund, who preferred not to be named, wanted to explore the similarities between the current telco debt and the S&L crisis' impact on extending the recession of the early 1990s. For more on this dialogue, join us at www.buyside.com for the video story.