FINANCIAL BUBBLES AND THE FED

Something is decisively wrong with the media's interpretation of what is happening to the financial markets and the economy. The press and the financial markets shiver as soon as Mr. Greenspan makes one of his famous yet obscure threatening pronouncements.

The excuse for the poor market performance of the past five months – and for the most recent market decline – is the hint by the chairman of the Fed that the speculative balloon has over-expanded and that a decline in equity values will have a negative effect on the economy. I know he is considered a demigod for his monetary policy leadership. Yet there is something that does not make any sense to me. Let me explain.

The stock market thrives on liquidity. This may sound like back-of-the-envelope economic analysis compared to the complex research done by top-ranking economists and the Fed. Yet I believe few people would disagree with me when I say that there is nothing like a central bank printing money aggressively to make equities rise and investors happy.

From the time the Asian crisis erupted in fall 1998, I have been correctly predicting that the Fed would have to inject heavy liquidity to cushion the US economy from Asia's financial woes. I also said this liquidity would be great news for the US economy and stock markets. This was exactly the opposite of what big name economists were saying. They feared a collapse of the global economy and of the US stock market.

The stock market soared for one reason: the growth of the money supply exploded and MZM reached a growth rate of 15%, a combination rarely seen in the past 50 years (I showed the chart in the last issue of *The Peter Dag Portfolio Strategy and Management*.) The so-called stock market bubble grew so large because there was a liquidity bubble in 1995-1998.

The problem I have with the recent statements of several Board Governors regarding asset inflation is that they had the tool to prevent this bubble. The Fed is the only institution I know of that controls the expansion of credit, that is of the money supply.

The rapid acceleration of the money supply (which simply measures demand for money) soared because the Fed met the demand coming from business. The stock market soared as some of this money went into equities. Yet as we were in the middle of this strong credit expansion, Mr. Greenspan was talking about "irrational exuberance." The reason for this exuberance was that investors did not know what to do with the money the Fed made available to them.

Do you see why I do not understand the interpretation given by Wall Street and its gurus on what is happening? In the February 22, 1999 issue of *The Peter Dag Portfolio Strategy and Management* I wrote "growth in the money supply will decline …" and then I added "[L]iquidity has been the main engine driving this market, and its slowdown will have a negative effect on the overall market."

The poor market performance that began soon after is history. I was absolutely correct to expect this due to slower growth in the money supply. Again, I based this forecast on simple economic analysis and the study of relationships that should be very familiar to the Fed. Changes in liquidity drive asset prices generally and stock prices in particular.

The Fed knew very well that it would create a financial and economic bubble by accommodating credit demand and letting the money supply soar from 1995 to 1998.

I cannot accept that they did not foresee the consequences of their action. Rising interest rates are the logical outcome of a bubble economy; they will continue to rise until two bubbles are punctured.

The first bubble is the stock market, which is being punctured now. The process started last spring and will continue for as long as interest rates keep rising. Then, sometime next year, the economy – the second bubble – will begin to slow down sharply. Only then will interest rates decline. This decline will result from lack of credit demand, certainly not by the easing of the Fed. Eventually lower interest rates will again ignite the engine that will start the ninth financial cycle since 1960.

But please, do not tell me the Fed does not understand this process that I correctly predicted. I learned it from reading books available in any public library.

My point is that the Fed itself pumped air into the two bubbles by allowing credit expansion to soar. Now we are witnessing the logical consequence of that decision. There is nothing the Fed or anyone else can do to stop what is going to happen in the next 18 months. Mr. Greenspan, in spite of his great mental energy, will be a spectator like all of us.

It looks like a crisis is brewing. The spread between lower-grade and higher-grade bond yields are rising as if something were deeply wrong. Likewise for the spread between market driven short-term interest rates and the rate on 13-week Treasury bills.

Spreads between Baa bond yields and Treasuries remain close to cyclical highs. Spreads between market driven short-term interest rates and the rate on Treasury bills soared to the levels of last fall, when the Brazilian crisis was in full swing.

The simple interpretation for such high spreads is that the demand for credit is too high and an increasing number of marginal borrowers need credit. Risk is therefore increasing and lenders are raising the price of money accordingly. But I believe there is a problem somewhere.

The obvious answer is Y2K. But it could be something else. No one can say for sure. High-risk premiums are associated with major financial failures and financial instability: high spreads point to substantial financial risk, and high risk suggests caution.

The business cycle continues to behave as expected with all its good and bad news. The economy is strong, short-term and long-term interest rates are rising in lockstep with increasing inflationary pressures. Inflation is low, but the fact is that inflation gauges have been moving up since mid-1998.

The lagging indicators that rise when the economy operates at close to capacity (interest rates, inflation, and wages) are heading up. However, their increase is not discouraging business to hire or borrow because these costs have not yet reached the pain level. The implication is that rates will have to rise until *do* inflict pain. Only then will the economy begin to slow down.

The growth of the money supply will continue to decline, reflecting a draining of liquidity from the economy as investment plans are gradually curtailed due to increasing costs.

The dollar will remain weak as the trade deficit is soaring, inflationary pressures are rising and the forces leading to an economic slowdown become more pronounced. The weak dollar reflects the economic imbalances of the US economy; it anticipates the coming economic correction.

As short-term and long-term interest rates keep rising at least until May 2000, the yield curve will flatten. This will develop as short-term interest rates increase faster than long-term interest rates. A 7% target for short-term and long-term interest rates is not unrealistic considering that short-term interest rates are already close to 6%.

The bottom line? *The environment for the financial markets is worsening*. The liquidity bath we enjoyed so much in 1995-1998 is past. The markets are taking over and doing what the Fed should have done in 1998. It is time to pay the piper. Investors must adopt a very defensive investment strategy.

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