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First Trust

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Monday Morning Outlook

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Bubble Trouble

Federal Reserve officials, academics and journalists seem fixated on the question of what the Fed should do – if anything – in the face of a "bubble" in financial asset prices, housing prices, or commodities. This debate was originally kicked-off in late 1996 when then Fed Chairman Alan Greenspan rhetorically asked if some sort of "irrational exuberance" had taken hold of the stock market, which had rallied strongly for two straight years.

The good news is that apparently there is a consensus at the Fed that monetary policy should *not* be used to "pop" bubbles. The bad news is that the Fed has yet to come to grips with the fact that mistaken monetary policy is often a primary cause of bubbles to begin with and that the world would be much better off if the Fed focused on one thing and one thing only – a stable value for money.

Part of the problem in analyzing bubbles and monetary policy is that the Fed never admits mistakes. As a result, market movements are considered exogenous – the Fed calls the 1990s stock market "irrational," Alan Greenspan still blames foreigners for the housing bubble that his 1% interest rate policy caused, while China and India get the blame for rising commodity prices. This kind of "shift-the-blame" analysis has created many problems, or made them worse.

In the late 1990s, for example, instead of ignoring the substantial rise in stocks and focusing on price stability, the Fed tried to curtail stock market gains. It kept money tight and held interest rates well above inflation. This policy boosted the dollar and encouraged foreign investment, while shifting investors away from real assets and toward US financial assets. In other words, at least initially, rather than curtailing the rise in the stock market, tighter monetary policy fueled even greater speculation.

When the Fed finally pushed rates too high by mid-2000, this all came to an end. For the next six quarters the economy grew at a 0.4% annual rate, including three quarters of negative growth. Meanwhile, the Dow Jones Industrials Average lost roughly 30% of its value from mid-2000 to the bottom in late 2002. Policymakers who argued for tighter money in 1999 suddenly started worrying about deflation, and argued that rates could not be cut fast enough.

A better strategy for the late 1990s would have been to set monetary policy to address the fall in the price of gold – which was signaling deflation – and make it clear that policymakers understood the strategy would lead to either a decline in the value of the dollar or slower appreciation in the dollar. Such a policy could have killed three birds with one stone: weakening a then super-strong dollar, diminishing speculative fervor and avoiding deflation.

If that had happened, the Fed would never have cut interest rates to 1%, and the "housing bubble" would have been avoided. Commodity prices today would also be much lower and the dollar would be stronger.

But this is where all this turns almost surreal. Because of pain associated with falling stock prices (2000-2002) and a collapse in the housing market (2006 and continuing), there are some who argue the Fed should ignore the commodity bubble and let it correct itself.

But this would be a huge mistake. Rising inflation is already locked-in and some are encouraging the Fed to ignore it because they think it is a bubble! But another year of easy money will make things even worse. The Fed itself causes bubbles by not adhering to a single mandate – price stability. All this talk of bubbles is letting that truth get lost in the noise.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-27 / 9:00 am	Consumer Confidence - May	60.3	**61.1**		62.3
9:00 am	New Home Sales - Apr	0.520 Mil	**0.526 Mil**		0.526 Mil
5-28 / 7:30 am	Durable Goods - Apr	-1.5%	**-3.3%**		-0.3%
7:30 am	Durable Goods (Ex-Trans) - Apr	-0.5%	**-1.3%**		1.6%
5-29 / 7:30 am	Q1 GDP Preliminary	0.9%	**1.2%**		0.6%
7:30 am	Q1 GDP Chain Price Index	2.6%	**2.6%**		2.6%
7:30 am	Initial Claims – May 24	370K	**368K**		365K
5-30 / 7:30 am	Personal Income - Apr	+0.2%	**+0.3%**		+0.3%
7:30 am	Personal Spending - Apr	+0.2%	**+0.2%**		+0.4%
9:00 am	Chicago PMI - Apr	48.5	**47.2**		48.3