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First Trust

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Monday Morning Outlook

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Reappoint Bernanke

Treasury Secretary Timothy Geithner recently said in an interview that the #1 policy mistake that helped cause our economic and financial turmoil was that "monetary policy around the world was too loose, too long."

Some people may think this was Geithner's way of throwing Federal Reserve Chairman Ben Bernanke under the bus. After all, although former Fed Chair Alan Greenspan has been getting the lion's share of the blame for overly loose money earlier this decade, Bernanke was on the Fed Board from 2002 to 2005. Back then, it was Bernanke who argued that a sustained drop in short-term interest rates could bring down long-term rates. During that period, he even earned the nickname "Helicopter Ben" for suggesting (correctly) that the Fed could fight deflation by dropping money from a helicopter.

Despite Alan Greenspan's public claims that his monetary policy was not too loose, we think Secretary Geithner is absolutely correct. In fact, we have a long track record of saying monetary policy was too loose for too long, including Op-Ed pieces in the Wall Street Journal stating clearly that 1% interest rates were too low.

Typically, Washington power players circle the wagons around these kinds of policy mistakes, but for some reason the Obama team has not done so, at least this time. And while we give Chairman Bernanke poor marks for his monetary policy decisions in recent years, President Obama could help the economy by making an early announcement that he intends to re-nominate Bernanke for another term as Fed chairman to start on January 30, 2010. This would close the door on the only other serious contender: Larry Summers.

In some other presidency with a different economic agenda, Summers might be an appropriate choice. Like during the Clinton presidency, when freer trade, deficit reduction, and welfare reform all topped the agenda.

But the overriding theme of this president's agenda is that the government can manage the economy better than the private sector, in health care, banking, autos, energy, carbon emissions, or even mundane issues such as compensation practices at financial firms.

In this environment, choosing Summers would suggest the president sees monetary policy as just another economic lever for the government to manage, depending on which way the political wind blows. The result would be much higher long-term interest rates as Treasury investors worldwide would have to increasingly price-in the risk that the US might try to inflate its way out of its long-term over-spending problem.

This possibility may be the reason why there is such a large gap between interest rates on the 30-year Treasury bond and the benchmark 10-year Treasury note. Typically, this gap has been about 40 basis points, but right now the gap is an abnormally high 95 basis points. Any argument that a "flight to safety" toward the more liquid 10-year doesn't make sense – the yield gap has widened despite falling risk in the past few months.

This spread suggests the Fed needs to raise interest rates from near 0% back toward normal. At first, these rate hikes will be relatively easy to do, and pushing rates back to about 3% could probably happen with little pain.

But given how loose the Fed has been in the past year, rates may have to go up significantly above 3%. Then the issue becomes which economic doctor can deliver monetary tightening with the least pain for the patient.

Because Bernanke would be trusted by the markets to be more independent of the current administration, we think he is clearly the superior choice. In fact, the markets may demand more aggressive tightening action from Summers then they would from Bernanke.

By reappointing Bernanke, the message to the markets would be that the Fed is less likely to make the same mistake of being too easy, for too long, all over again.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-19 / 7:30 am	Housing Starts - Apr	0.520 Mil	**0.560 Mil**		0.510 Mil
5-21 / 7:30 am	Initial Claims - May 16	625K	**638K**		637K
9:00 am	Philly Fed Survey - Mar	-18.0	**-17.0**		-24.4
9:00 am	Leading Indicators - Apr	+0.8%	**+1.4%**		-0.3%