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First Trust

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Monday Morning Outlook

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Bernanke and the Teflon Fed

The Federal Reserve acts like an academic institution, and in many ways it resembles one. But it operates in a political environment and it is really good at navigating the landscape.

It can be argued that Alan Greenspan (Chairman of the Federal Reserve 1987-2006) was one of the most successful politicians ever to set foot in Washington DC. He never won an election, but was called the "maestro." His critics (those brave enough to challenge him) could not scratch his Teflon coating.

Lately, he has come under attack for the housing bubble. And even though it is clear that 1% interest rates back in 2004 had a huge role in causing over-investment in housing, the Fed and Greenspan have once again come through unscathed.

One could argue that the Bernanke press conference was forced by some politicians (like Congressman Ron Paul) who do blame the Fed for causing problems. That would be partly true. But the presser was the next logical step in a two-decade process of moving the Fed toward more transparency.

While many people are thrilled with this new level of transparency (especially the press), we believe it is all useless if Americans don't understand monetary policy.

For example, Ben Bernanke said that quantitative easing (both QE1 and QE2) helped ease "financial conditions." This means it drove down interest rates, caused credit spreads to narrow and lifted stock prices. He then said, "*You would expect, based on decades of experience, that easing financial conditions would lead to better economic conditions.*" In other words, the Fed is taking credit for the recovery and job creation.

At the same time he denied any responsibility for rising oil prices, flippantly saying, "*after all, the Fed can't create more oil.*" This ignores the fact that oil is priced in dollars and the Fed is the only entity in the world that can create more dollars.

So, if we listen to Ben Bernanke, the Fed is responsible for all the good things happening, but not responsible for anything that is considered bad. On its surface, this is not plausible. If QE is powerful enough to drive up the price of all US assets, why not oil prices?

His entire argument is full of holes. If quantitative easing really does drive up asset prices directly, then price-earnings ratios should have risen. But P-E ratios have remained flat (or even fallen by some measures). Profits are rising as fast as the price of equities.

The Federal Reserve can only manipulate one thing – the supply of money. And if printing money created wealth, why not make counterfeiting legal? But money has never created a job, or a new drug, or an iPad app. Printing money distorts the economic landscape. In 2003-2005, 1% rates put a mortgage broker in every strip mall.

Today, with short-term interest rates near zero, there are more distortions. Cash for gold stores are on every corner of the land and oil prices and gas are reminding everyone of the 1970s. But, don't look for this to change any time soon. Bernanke made all of this very transparent – he sees nothing wrong with Fed policy and so we expect these zero percent rates to be with us until mid-2012.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-2 / 9:00 am	ISM Index - Apr	59.5	**60.5**	60.4	61.2
9:00 am	Construction Spending - Mar	+0.4%	**+0.5%**	+1.4%	-2.4%
5-3 / 9:00 am	Factory Orders - Mar	+2.0%	**+2.3%**		-0.1%
afternoon	Domestic Auto/Truck Sales - Apr	9.9 Mil	**10.0 Mil**		10.0 Mil
5-4 / 9:00 am	ISM Non-Man. - Apr	57.5	**58.3**		57.3
5-5 / 7:30 am	Q1 Non-Farm Productivity	+1.1%	**+1.9%**		+2.6%
7:30 am	Q1 Unit Labor Costs	+0.8%	**+0.1%**		-0.6%
7:30 am	Initial Claims - Apr 30	410K	**415K**		429K
5-6 / 7:30 am	Non-Farm Payrolls - Apr	185K	**195K**		216K
7:30 am	Private Payrolls - Apr	200K	**220K**		230K
7:30 am	Manufacturing Payrolls - Apr	20K	**30K**		17K
7:30 am	Unemployment Rate - Apr	8.8%	**8.8%**		8.8%
7:30 am	Average Hourly Earnings - Apr	+0.2%	**+0.2%**		0.0%
7:30 am	Average Weekly Hours - Apr	34.3	**34.3**		34.3
2:00 pm	Consumer Credit - Mar	+$5.0 Bil	**+$6.0 Bil**		+$7.6 Bil