UPDATE

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"But what they perceive as newly abundant liquidity can readily disappear. Any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums."

-Alan Greenspan, former Chairman of the Federal Reserve

The Journey to Instability

It was in a rare moment of coherence when former Federal Reserve Board Chairman Alan Greenspan gave the above mea culpa to the markets. This quote, given in August 2005 at a symposium in Jackson Hole, Wyoming entitled, "The Greenspan Era: Lessons for the Future," neatly, if not inadvertently, summarizes the exceptions we have taken to the macroeconomic policy of the Greenspan era. It was Greenspan himself who offered up the "*newly abundant liquidity*" to the markets in an effort to soften the blows from the bursting of the technology stock bubble…the same bubble his policies inflated. In so doing, he created the now infamous "Greenspan Put," or the notion that investors should not fear risk for if problems arose, Al Almighty would come to their rescue.

The Greenspan Put is the inevitable result of the *Asymmetric Central Bank Reaction Function* (the aggressive use of monetary accommodation during an economic downturn, and the much less aggressive removal of said accommodation as the economy recovers), and the Greenspan Fed's subsequent failure to recognize the asset bubbles this asymmetry creates. John Mauldin, author and fund-of-funds manager, believes that this asymmetry blossoms from fear of deflation. In his May 30, 2006 Thoughts from the Frontline newsletter Mauldin wrote, "Central bankers…tolerate mild inflation but do not tolerate deflation. Indeed, when inflation gets too low, as it did in 2002, they drop rates dramatically to avoid it, or pursue low rates and quantitative easing as they did in Japan in the early part of this decade."

Certainly the deflationary woes of Japan during the past decade gave the Federal Reserve reason for providing medicine when our economy was sick. Indeed, Ned Davis of Ned Davis Research, Inc. believes that the 2000-2002 U.S. bear market would have sent us into a serious deflationary recession similar to Japan if the Fed hadn't "pulled out all the stops" in terms of money supply growth and 1% short-term interest rates. Adding to this monetary accommodation was an assist from easy fiscal policy in the form of tax cuts and federal budget deficits.

The trouble is that the Greenspan Fed proceeded at a "measured" pace in removing accommodation from the markets when the economy got over its coughs and sniffles. In his July Global Central Bank Focus, PIMCO's Paul McCulley wrote, "It is an inconvertible truth that the Fed under Greenspan ran an asymmetric reaction function, with market participants fully aware that was what the Fed was doing." In a separate article entitled Is Price Stability Enough, William R. White, Head of the Monetary and Economic Department of the Bank of International Settlements (what Mauldin calls the central banker's central bank), cautions investors against the pitfalls of such monetary policy. "Central banks respond to slowdowns with an easy monetary policy, but do not respond to asset bubbles, allowing them to develop, thus creating the conditions for future instability."

By slowly removing monetary accommodation, McCulley says the Fed was acting as an insurance agent for the markets. In his June Global Central Bank Focus**,** McCulley wrote that the Fed was "underwriting risks that the global markets would otherwise have had to absorb and price. This is called moral hazard. With policy makers removing sources of volatility risk from markets, actual volatility falls, which like gravity, pulls risk premiums lower. This is a perfect prescription for bubbles."

As we have discussed (ad nauseum some may say) in past *Updates*, one result of the latest round of monetary accommodation was an enormous housing market bubble. In the June edition of Barron's, Alan Abelson wrote in his Up & Down Wall Street column that, "When equities inevitably came back to earth [from their 2001 bubble highs]…[Greenspan] sought to distract us simple folk from the smoking ruins by creating the greatest housing bubble since shelter-seeking man first crawled out of his dank cave." Bulls will argue that the housing bubble does not matter because as home prices decline homeowners will simply hold on to their houses until the market recovers. This argument misses the point entirely as it fails to recognize the role debt played in the housing boom and how important this debt was to our economic recovery.

As risks were mitigated by the Greenspan Put, Joe Consumer bellied up to the debt bar and Al Almighty was ready to serve. In what Stephanie Pomboy of MacroMavens terms Greenspan's "call to ARMs", the former Fed chairman encouraged consumers to fill their refinancing cups with adjustable rate mortgages (ARMs), and fill them they did. Banks, itching for an alternative to low-yielding U.S. Treasuries (think 1.0% Fed Funds rate), were more than eager to stock the shelves with the intoxicants Greenspan was serving. As a result, Pomboy believes that the U.S. banking system is more exposed to the real-estate sector than at any time since the end of World War II. She estimates, "banks have $3 trillion in direct mortgage loans sitting on their books, which happens to be a record 43.0% of total bank assets."

Chart 1

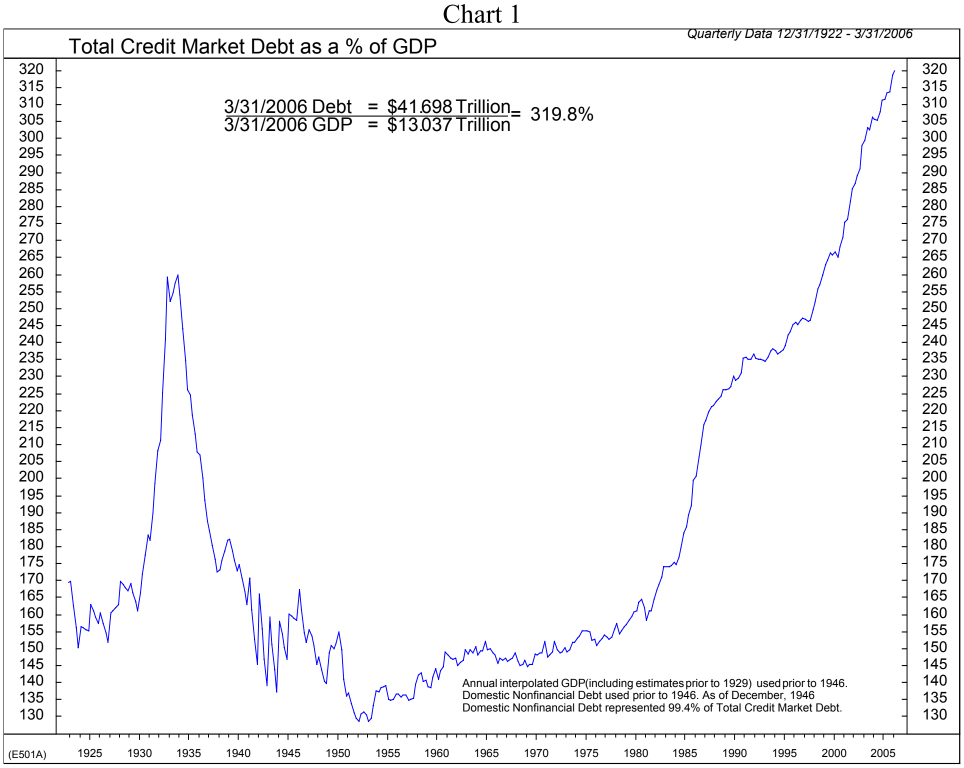

Chart courtesy of Ned Davis Research, Inc.

A quick glance at Chart 1 gives an idea of just how much debt was needed to fuel our recent expansion. From the already lofty level of $26 trillion in March of 2001, total credit market debt now stands at a record $41.7 trillion, or about 320% of GDP (far eclipsing the debt-to-GDP levels seen in the Great Depression). Pomboy estimates that fully 67.0%

of this credit market issuance since 2001 has taken the form of claims on the consumer, and according to Ed Hyman of ISI Group, Inc. we have never before seen a surge in mortgage equity withdraw (MEW) like have seen since 2001. (See Chart 2.)

Chart 2

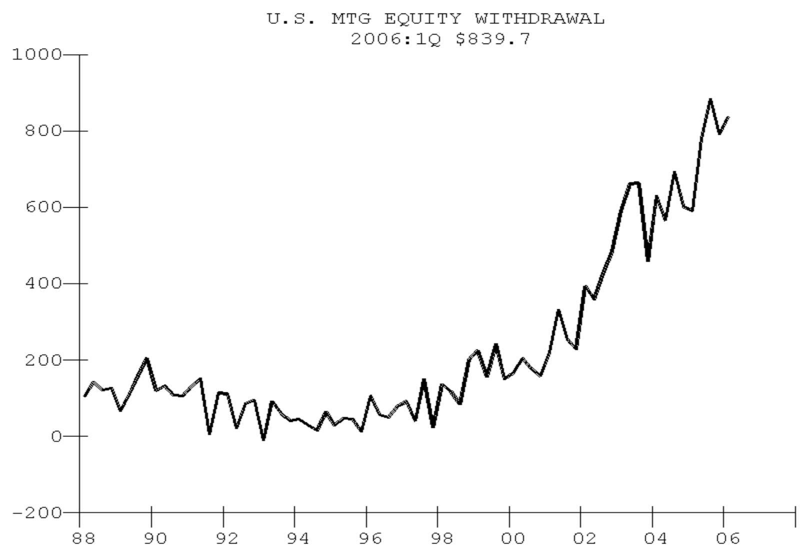

Chart courtesy of ISI Group, Inc.

Hyman believes this remarkable acceleration in debt has prolonged this economic expansion. We would add that, by doing so, it has also allowed for rising short-term inflationary pressures. According to Hyman, U.S. inflation reports in May were on the higher side including the core (ex-food and energy) producer price index (PPI), the core consumer price index (CPI), the Philadelphia Fed manufacturing prices survey, the New York manufacturing prices survey and the Fed's Beige Book commentary on prices. For the first time in ten years, the May core CPI rose 0.3% month-over-month, boosting the year-over-year core inflation rate to 2.44%. Adding more risk to the domestic inflation story, prices have begun to accelerate in China and India, two of the larger outsourcing destinations for U.S. corporations. Yet wages are the inflation fire-break. After raising the Fed Funds rate to 5.25% on June 29, 2006, the Federal Open Market Committee said the muted rise in unit labor costs has key inflation expectations contained. They did caution, however, that "high levels of resource utilization…have the potential to sustain inflation pressures."

Chart 3

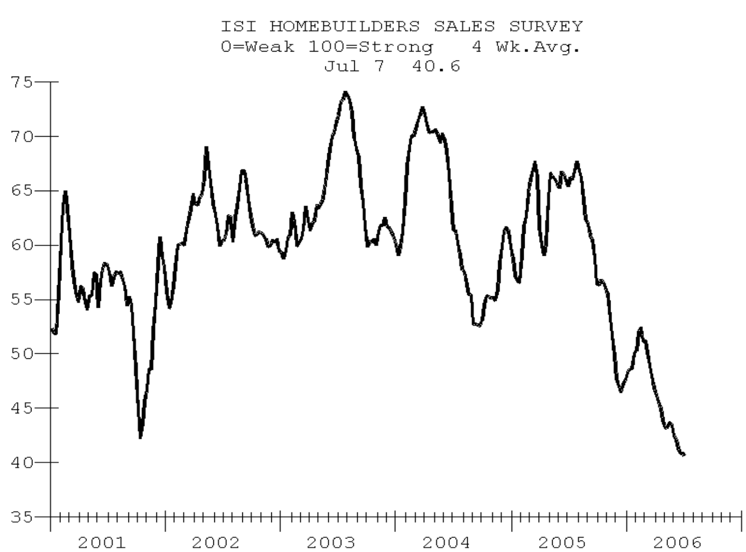

Chart courtesy of ISI Group, Inc.

So here we are. Inflation is now above new Federal Reserve Chairman Ben Bernanke's "comfort zone," leaving the Fed with little choice but to raise rates. Already the Fed has raised rates higher than the beginning-of-the-year consensus forecast. The pain, in short, is being felt. The National Association of Realtors has publicly asked the Fed to pause "because some housing markets have become vulnerable" to higher rates. ISI's homebuilders survey is a near-record low (see Chart 3), and the National Association of Home Builders housing market index has its largest eight-month decline on record (see Chart 4).

Chart 4

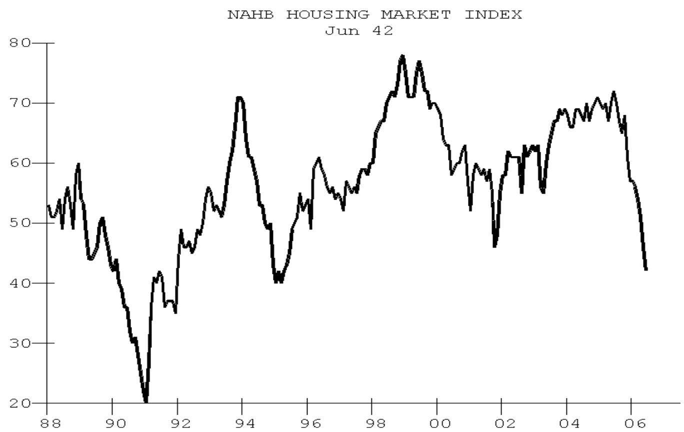

Chart courtesy of ISI Group, Inc.

The consumer is weighing in as well. The June University of Michigan Consumer Confidence Index came in at 84.9, a depressed number that is indicative of consumer dissatisfaction with the economy. In his June 6, 2006 Thoughts from the Frontline newsletter, John Maldin wrote, "slower wage growth, less discretionary money available, a slowing housing market, the saving rate already so low that there is not much room for it to drop. It all sounds like there is the serious potential for a consumer spending slowdown that could lead to an economic slowdown later this year."

As interest rates rise, the debt that has propelled consumer spending forward is increasingly less available. According to Stephanie Pomboy, "the thing which enabled consumers to deflect these headwinds until now…borrowing more…no longer exists as an option. Not only are interest rates rising, but even those consumers who'd be willing to pay-up to borrow are finding it increasingly hard to do so. With home prices no longer on the rise, the equity well is running dry."

And just staying put and waiting for the housing market to recover may not be a viable option for many consumers. An Associated Press article from the June 25, 2006 edition of the *St. Petersburg Times* entitled Foreclosures in the Forecast indicates some consumers are finding they can't refinance their mortgages as their ARMs adjust, and they are now trapped into higher payments they can't afford. Apparently, falling home values and low levels of home equity are making it impossible for investors to find a way out. According to Ned Davis, "some $2 trillion in adjustable rate mortgages are estimated to be eligible to have rates rise in 2006-2007." Ned believes these ARM resets are the weakest link in our economic chain. "So the 'chain' is going to be tested," Ned wrote. "[These] problems…could impact all of us. The debt could implode on the financial system, and then nearly all of us could be at risk."

When the curtain closed on the Greenspan era the markets gave a standing ovation. They applauded his inflation fighting zeal and his steadfast commitment to price stability all the while ignoring the obvious imbalances that he built because of these policies.

Paul McCulley concludes that, "too much success in stabilizing…inflation, while conducting an asymmetric reaction function to asset price inflation…is a dangerous strategy. Yes it can work over time. But precisely because it can work for a time, it sows the seeds of its own demise….because of the asset price and credit excesses that stability begets.

"Stability can never be a destination, only a journey to instability."

Keep your seat belts fastened.

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