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First Trust Advisors L.P.

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Monday Morning Outlook

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No More Greenspan Put

From 1981 to 2001, the Federal Reserve Board focused intently on eradicating inflation. Price increases had gotten out of control in the 1970s, causing wide economic fluctuations – booms quickly followed by busts – and eroding the economy's long-term potential to grow.

From 1970 to 1982 we experienced four recessions and successively weaker expansions in between. Before the 1970 recession unemployment bottomed out at 3.4%; before the 1973-75 recession it only fell to 4.6%. The jobless rate stopped falling at 5.6% before the 1980 recession, and a higher 7.2% prior to the 1981-82 recession.

The economic benefits of getting inflation under control were large. Since 1982, only two recessions have occurred – both relatively short and shallow. Meanwhile, we have achieved lower lows in the unemployment rate, with a bottom of 5% before the 1990-91 recession and 3.8% before the 2001 recession.

The Volcker Fed did most of its work against inflation in 1981-82, when the federal funds rate went up to 19%. Year-to-year CPI inflation, which had peaked at 14.6% in early 1980, bottomed out at 2.5% by mid-1983.

When Alan Greenspan became chairman, inflation was moderate, but inflationary expectations had not been eradicated. Real interest rates remained high because the markets did not fully trust the Fed.

As a result, the Fed instituted a strategy called "opportunistic disinflation," which meant it would tighten policy when the economy was strong, often times by holding the federal funds rate steady as inflation fell. This helped anchor inflation, but when the economy slowed or there were problems in financial markets, often because of tight money, the Fed would cut rates sharply and swiftly.

The Fed did this in 1987 after the stock market crash, and then again in September 1998 after Long Term Capital Management (LTCM) collapsed. So, *as intended*, monetary policy would go through prolonged periods of being a little too tight given economic conditions, and then abruptly shift to short periods when policy would be loose.

This policy of cutting rates forcefully when markets seized up became known as the "Greenspan Put." Investors began to expect it, and every time the Fed rescued the markets the perceived risk of leverage declined. Eventually, as the economy recovered from each event, the Fed re-tightened, until it tightened too much in 1999 and 2000, creating deflation and a stock market crash.

But this time, the Fed was not able to turn things around with just a few rate cuts as it had in the past. In 2001, it cut rates eleven times, eventually lowering the federal funds rate to a 45-year low of 1%. Although these amazingly low interest rates did not prevent a recession they did start re-inflating the economy and, combined with a continued belief in the Greenspan Put, encouraged even more financial leverage. Credit spreads declined sharply and the housing market surged above its trend. This was the logical end point of the Fed's policy of coupling opportunistic disinflation with the Greenspan Put.

Now, with credit spreads widening and equities weak, the markets want the Fed to cut rates again. But if the Fed cuts rates, and reaffirms the Greenspan Put, it will boost inflation further and encourage more financial leverage. As a result, the Bernanke Fed is reluctant to ease. It wants the market to sell its Greenspan Puts. It wants investment decisions to be based on underlying economic activity, not second guessing the Fed.

That is why we expect the Fed will keep rates at 5.25% at tomorrow's meeting and for the rest of this year. We also doubt the Fed will refrain from altering the balance of risks, which tilt against inflation, rather than slow growth. The financial markets don't want to part with the Put. But the benefits of price stability will make it a worthwhile trade.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-7 / 7:30 am	Q2 Non-Farm Productivity	+2.1%	**+2.5%**		+1.0%
7:30 am	Q2 Unit Labor Costs	+1.6%	**+0.5%**		+1.8%
8-8 / 9:00 am	Wholesale Trade Sales - Jun	+0.5%	**+0.0%**		+0.5%
8-9 / 7:30 am	Initial Claims - Aug 4	310K	**306K**		307K
8-10 / 7:30 am	Import Prices - Jul	+1.1%	**+0.7%**		+1.0%
7:30 am	Export Prices - Jul	+0.3%	**+0.2%**		+0.3%
1:00 pm	Treasury Budget Statement - Jul	-$34.0 Bil	**-$28.9 Bil**		-$33.2 Bil