ON THE MONEY

How the Fed boxed itself — and you — in

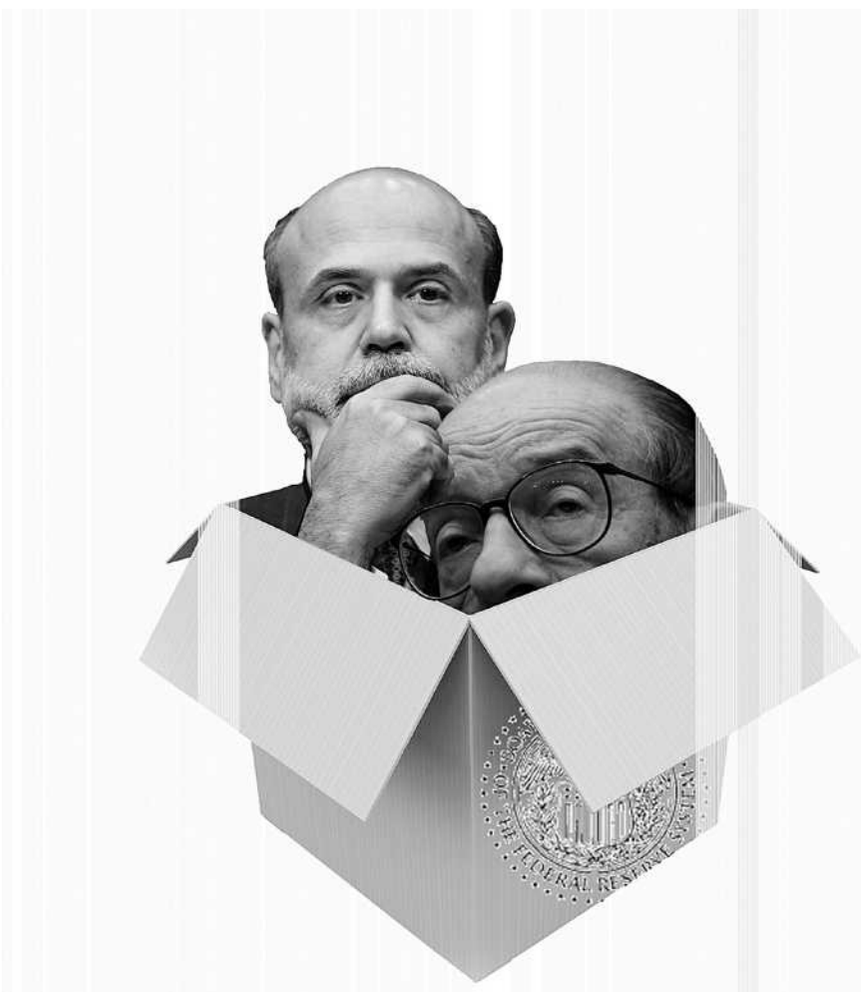
BARRY RITHOLTZ
On Investing

Last week, the Federal Reserve announced it was lowering its forecast for the U.S. economy. The Fed now sees signs that economic growth is decelerating, job creation is soft and that deflation — not inflation — is the greater threat. In response, the Federal Open Market Committee took the unprecedented step of declaring they will leave interest rates at zero until mid-2013.

This policy announcement of "Two more years!" is a tacit admission that the U.S. Central Bank has painted itself into a corner.

How this unfolded is a sordid tale, with major ramifications for investors. I'll share with you what I told clients this week: "This entire crisis traces itself back in large part to then-FOMC chair Alan Greenspan not allowing markets and the economy to flush themselves clean after the dot-com collapse. It seems that nearly every Fed/government policy action has been a response to the problems that error led to."

The Fed — unlike most other central banks — has a dual mandate: to maintain full employment and, at the same time, keep inflation at bay. History informs us that these two factors are often at odds: Growth usually begets price increases, and excessive price elevation retards growth. Hence, for the Fed to do its job well, it has a neat balancing trick to perform.



WASHINGTON POST PHOTO ILLUSTRATION

In the 1990s, the Fed drifted away from those mandates when Greenspan began focusing on markets, asset pricing and a nonsensical catch-all he called "investor confidence." (Others might point you to earlier dates — you might check out Bill Fleckenstein's book "Greenspan's Bubbles.")

With the bull market in full charge, Greenspan watched investor confidence more and more. This is a tough crowd to play poker with, and once traders deduced that Greenspan was concerned about their sentiment, his cause was lost. It became quite apparent that at the first sign of any market spasm, the Fed stood ready to flood the system with liquidity. In just four short years, markets saw massive Fed responses to 1) Asian contagion (1997); 2) Russian bond defaults and 3) Long-Term Capital Management collapse (1998); 4) Y2K bug (1999); 5) dot-com implosion (2000); and 6) 9/11 (2001).

Thus was born the Greenspan put. Investors had determined that Greenspan would not allow stocks to drop appreciably. This led to appreciably more aggressive trading postures, increased usage of leverage and an overall embrace of risk.

There was no small irony in this. Greenspan — Mr. Free Markets himself — had somehow morphed into Mr. Centrally Planned Economy. This was not lost on the Wall Street community, whose bonuses depended on sniffing out the most lucrative opportunities. What was becoming the obvious answer to that question was wherever Fed liquidity was driving asset prices. For the late 1990s, the answer was upward.

After the Y2K cash infusion on Oct. 22, 1999, the Nasdaq doubled, from 2,500 to 5,100, in six months. The 78 percent collapse it suffered overstates what should have been a more typical 50 percent crash (say, 2,500 down to 1,250) had the Fed intervention not occurred. (Savvy traders saw parallels to this in August 2010, when the Fed announced QE2.)

Then came the dot-com crash. Fed Funds rates were at 6 percent in early 2001 before the Fed began slashing them. They made eight rate moves between January and August 2001, cutting rates in half, to 3 percent. Note that this was before the Sept. 11, 2001, attacks. It looked to this observer that Greenspan was panicked by the market reaction to the terrorist attacks: He took rates all the way down to 1.25 percent. At the time, it was unprecedented to have rates below 2 percent for three years, and at 1 percent for a year.

This unprecedented Fed intervention unleashed a series of unfortunate events: Bond managers scrambled for yield, ultimately finding AAA-rated mortgage-backed junk products. The dollar plummeted 41 percent during the next seven years. Anything priced in dollars — oil, gold, foodstuffs — skyrocketed, sending inflation screaming higher. Housing took off, loan standards collapsed, credit quality suffered.

Of course, there were other factors: Radical deregulation, globalization, labor restructuring, flat income, the rise of Asia and more. But it's hard to imagine the rest of the 2000s as the debacle it became without this initial Fed overreaction.

Indeed, we can only imagine what the 1990s and early 2000s would have been like had the FOMC been more Volcker and less Greenspan. Former Fed chair Paul A. Volcker was a no-nonsense central banker who believed that the Fed's job was to fight inflation. Whatever happened in the stock market was none of his concern. If you bought Russian bonds and they defaulted, you were supposed to lose your money. Bought into a bad hedge fund that blew up? You took the hit! The dot-com collapse should have led to a flushing- out recession and market crash that took a few years to recover from. Not, as was the case, an attempt to offer a salve to leveraged traders who were caught leaning the wrong way when the tide went out.

What we got instead was the Greenspan Fed. The ills caused by cheap money and excess liquidity were apparently to be solved by even cheaper money and more liquidity.

Many of the subsequent problems of the U.S. economy derive from those decisions from a decade or more ago. They have been compounded by a variety of other bad calls; it's not all the Fed's fault. But much of what ails us traces back to the Greenspan Fed.

The easy money that corrupted Wall Street and shook the world economy was the prime spark to the wildfire. Had a more normalized Fed policy been in effect, much of what took place in the 2000s very well would have gone down quite differently. We most likely would have had a deeper, more painful recession in 2007-09, but we would be further along the path to recovery today.

Instead, we are like the late-night reveler who forestalls the hangover by having another drink. And another. And another, until we discover that we have become alcoholics.

For the long-term investor, this has created all manner of problems. Fixed-income yields remain thin; those seeking to live off of their assets find it increasingly challenging to do so. Stocks that yield dividends can help, but they come with additional risk and volatility. The average investor is not a momentum trader, but that momo crowd squeezes the most profit out of an easy Fed.

Which brings us back to this week's FOMC announcement. We won't see protestors in the street carrying signs reading "Two More Years!" but that is all it has left to give. The Fed cannot raise rates, lest it triggers another recession. And the Fed cannot keep rates here forever, lest it admits its own policy failures, debase the currency further and send oil over $100 and gold toward $2,500.

It is boxed in. And it has no one to blame but itself.

Barry Ritholtz is chief executive of FusionIQ, a quantitative research firm. He is the author of "Bailout Nation" and runs a finance blog, The Big Picture.

STEVEN PEARLSTEIN

Mr. CEO, your Frankenpols are now beyond your control

PEARLSTEIN FROM G1

or two off your tax rate, but you were concerned it would look like special-interest rent-seeking. So when the Washington lobbyists came up with the clever idea of launching a campaign against over-regulation and over-taxation, you threw in some money, backed some candidates and financed a few lawsuits.

The more successful it was, however, the more you put in — hundreds of millions of the shareholders' dollars, laundered through once-respected organizations such as the Chamber of Commerce and the National Association of Manufacturers, phony front organizations with innocent-sounding names such as Americans for a Sound Economy, and a burgeoning network of Republican PACs and financing vehicles. And thanks to your clever lawyers and a Supreme Court majority that is intent on removing all checks to corporate power, it's perfectly legal.

Somewhere along the way, however, this effort took on a life of its own. What started as a reasonable attempt at political rebalancing turned into a jihad against all regulation, all taxes and all government, waged by right-wing zealots who want to privatize the public schools that educate your workers, cut back on the basic research on which your products are based, shut down the regulatory agencies that protect you from unscrupulous competitors and privatize the public infrastructure that transports your supplies and your finished goods. For them, this isn't just a tactic to brush back government. It's a holy war to destroy it — and one that is now out of your control.

For years, you complained bitterly about the uncompetitive nature of an employer-based health-care system, the inexorable rise of health insurance premiums, the folly of medical malpractice and the unfair burden of having to subsidize the uninsured. But when your lobbyists and your bought-and-paid-for politicians had the chance to cut a deal that would have given you most of what you asked for, they walked away.

For years, you complained bitterly about rising federal budget deficits and a corporate tax code that was too complex and burdensome. But when your crew had the chance to strike a grand bargain that would have fixed both those things, they not only rejected it but also insisted on creating an unnecessary crisis that triggered a credit downgrade of U.S. Treasurys and a roller-coaster ride for stocks.

Please don't tell me about your mealy-mouthed letter warning Congress not to play politics with the debt ceiling. By that point, the Frankenpols you created were not interested in your advice. The only thing that might have got their attention was a threat to cut off the flow of political money. You didn't — and now they know they can ignore you with impunity.

I wonder how many of your fellow members of the Business Roundtable would accept a credible budget-balancing deal that had $10 of spending cuts for every $1 of tax increases. My guess is they all would. And what about the presidential candidates in the new, improved Republican Party that you helped create? In last week's Iowa debate, every last one of them promised to veto such a deal. Good luck with that!

Remember way back last fall when your big concern was with regulatory uncertainty, which you continue to use as the excuse for letting all those profits build up on your balance sheet rather than investing in equipment or hiring workers? Whatever uncertainty you can pin on the Obama administration and the Democratic Congress now looks like small potatoes given the uncertainty caused by your political shock troops as they challenge every new regulation all the way to the Supreme Court. They'll try to prevent or roll back implementation of others with appropriations riders, just like they did with the Federal Aviation Administration — and we know how well that worked out.

In your name, they are also refusing to confirm nominees to dozens of key vacancies in the executive branch and independent agencies. Among them is President Obama's choice for Commerce secretary, John Bryson, who for 18 years was chief executive of the largest electric utility in Southern California and served as a director at Boeing and Disney. His sin, apparently, is that he was co-founder of a respected environmental organization, the Natural Resources Defense Council, and — get this — actually believes the scientific community when it says global warming is a problem.

I can just hear it now: "Mr. Bryson, are you now, or were you ever, a member of an environmental organization?" How does it make you feel to know that you've helped to revive McCarthyism in American politics?

Your culpability, however, extends beyond the breakdown in Washington.

For the past 30 years, there has been a steady financialization of the American economy in which the interests of so-called shareholders have become the single-minded focus of large corporations, to the virtual exclusion of the interests of customers, employees and the society at large.

Early on, some of your predecessors were willing to put up a fight against the Wall Street cabal, but in time they bought you off with exorbitant perks and pay packages that nearly rival their own. This occupation of Main Street by Wall Street was confirmed again last week as anonymous traders and hedge fund managers went on a riotous spree, wielding false rumors and high-frequency computerized trading to loot pension and retirement accounts and rob consumers and real investors of whatever confidence they had left.

I suppose there are some schnooks who actually believe that those wild swings in stock prices last week represented sober and serious concerns by thoughtful, sophisticated investors about the Treasury debt downgrade or European sovereign debt or a slowdown in global growth. But surely such perceptions don't radically change each afternoon between 2 and 4:30, when the market averages last week were gyrating out of control.

This week's New Yorker cover takes Corporate America to task.

The only credible explanation for that is speculation, herd behavior and market manipulation by traders looking to make a quick million — financial wiseguys who could not care less what impact it might have on the real economy. And other than J.P. Morgan's Jamie Dimon, I didn't hear a peep of protest from you on CNBC, or a speech to the Economic Club of Chicago or even a simple letter to the editor of the Wall Street Journal. A cameo appearance at the White House doesn't quite cut it.

It's not just that you have remained silent as the financial sector has sucked away much of the profit generated by the private sector, stolen away much of the nation's best talent and transformed the process of capital allocation and formation into a casino. Even worse, through organizations such as the Chamber and the Business Roundtable, you reflexively provided them with crucial political support that allowed them to beat back regulators who tried to restrict their growth, curb their risk-taking or put a stop to the kind of fraudulent activity that nearly sank the recovery, and from which it will take years to recover. Given your role in society and in the economy, your silence amounts to complicity.

The truth is you've become them. Instead of focusing your attention and ingenuity on developing new products and services, you're spending most of your own time on financial engineering — buying up companies at one moment because of synergies and cost saving, then spinning them off the next moment because they no longer fall within your "core mission."

The big innovation at Kraft these days is to separate its overprocessed food (Jell-O, Velveeta, Oscar Meyer) and unhealthy snacks (Cadbury chocolates, Oreo cookies, saltine crackers) into two companies.

Conoco-Phillips, which embraced hyphenation when it decided to merge into a vertically integrated oil company, has now decided that the world would be a better place if it spun off its refining and distribution business from exploration and drilling.

And let's not forget Medco, the pharmacy benefit manager, which was bought and then spun off by Merck into an independent company again until it was scooped up by Express Scripts, one of its biggest competitors.

I'm not exactly sure how we're going to generate more jobs and generate stronger growth in this country, but I'm fairly certain those kinds of bold initiatives aren't going to do the trick.

Hey, but don't worry about us. Enjoy that fly fishing in Montana. You deserve it.

pearlstein@washpost.com

THE COLOR OF MONEY

When hard times force fast calls on retirement planning

COLOR FROM G1

money. If she invests it, and all goes as planned, she could generate the same amount, if not more income, than the annuity would have provided.

But that's a big if. Is she capable, on her own or with the help of a financial adviser, to take on the investment risk herself? Would she panic in the future when the Dow fluctuates wildly?

On the other hand, the annuity payment is a guaranteed monthly stream of income. What if her former company goes out of business? She didn't know that the Pension Benefit Guaranty Corporation (pbgc.gov), a federal agency, is responsible for paying the benefits of failed pension plans. Its operations are financed by insurance premiums and with assets and recoveries from failed plans. The maximum payment for plans that are taken over this year is $4,500 a month for someone age 65. Her annuity payment is well below that amount.

- She's got to decide whether she wants to keep her 401(k) where it is or roll it over to an IRA. If she does the rollover, she'll have to decide how to invest this money, too.
- How aggressive should she be in her investment choices? The returns have to be enough to stay ahead of inflation. At 65, she still could have 20 years or longer to live off that money.
- Should she take Social Security now or wait until her full retirement age at 66? Can she afford to wait and collect at 70, when her benefit will be larger? She could live past the break-even point, at which time her waiting to collect a bigger check would pay off. AARP also has a Social Security benefits calculator to help with this decision.
- She's already signed up for Medicare, which is important to do when you turn 65. Otherwise, you could face higher premiums. She's got to run the numbers to see whether she can afford long-term care insurance. Medicare does not cover long-term care.
- Should she take some of her retirement money and pay off the mortgage on her condo, which she refinanced only a few years ago? I think she shouldn't take this option off the table. It would take about half of what she has saved to pay off her mortgage. However, it will get rid of her largest monthly financial obligation.

My friend has to gather more information before she can fully evaluate her choices. My questions made her realize that she had to do more research. Even with the assistance of a financial planner, she'll need to have a good understanding of her options.

"It just shouldn't be this difficult," she said. "It's a sin and a shame, as the old folks used to say."

Yes, it is. Retiring has become too complicated. People are expected to do calculations that include making guesses that would make anybody cry.

Readers can write to Michelle Singletary c/o The Washington Post, 1150 15th St. NW, Washington, D.C. 20071. Or e-mail: singletarym@washpost.com. Personal responses may not be possible. Please also note comments or questions may be used in a future column, with the writer's name, unless a specific request to do otherwise is indicated.