


 Max Bublitz

Open season at the Fed

Ben Bernanke's recent drive to increase transparency within the Fed is well-intentioned, but at times of financial stress the market needs strong leadership not 'free association sessions'

Transparency is the new buzzword in central banking circles. In fact, Fed supremo Ben Bernanke is so committed to showing how monetary policy sausage is made that he commissioned a task force headed by none other than vice-chairman Donald Kohn to explore methods for enhancing our viewing pleasure. The idea, at least in theory, is to reduce uncertainty and the attendant market volatility surrounding future policy decisions. Nevertheless, given the range of unconstrained and widely varying streams of consciousness flowing from various Fed sausage-makers lately, a little tweaking may be in order.

Recent Fed free association sessions have produced anything but the hoped-for volatility reduction. Hordes of English majors parse every utterance and highly caffeinated traders armed with super-computing hair-triggers stand at the ready to respond to every imagined Freudian slip. While these are clearly nervous times, this smacks of opportunity.

That's not to say that watching FOMC members deal with their myriad unresolved childhood issues is the only reason for the recent jump in volatility. No doubt the credit crunch and learning which bank will be the next to admit to huge SIV exposures have contributed to the volatility extremes. But a little judgement during such times would go a long way towards helping unclog the financial system. Group therapy at the Fed during a crisis doesn't do much to calm market jitters. Even though transparency is an admirable goal, there are times when getting policymakers to at least *appear* to be on the same page is essential.

Driving in neutral

Central bank management training issues aside, the Fed has its hands full. The October 31 move to 'neutral' was a mistake as the economy was clearly weakening. I don't expect the US to fall into the technical definition of a recession, although significant monetary reflation will be needed to loosen up the credit markets and

to generate a recovery. I'll leave the hand-wringing about moral hazard and inflation to those so inclined, but neither have any relevance in the current environment. Given the deflationary impacts of a housing recession and credit crunch at this point in the economic cycle, it wouldn't surprise me if *deflation* were to become the market's worry *du jour* as we approach mid-2008. Nominal GDP should trough in the 3.5% range around that time.

Where the Fed funds rate ultimately needs to reside relative to GDP in that scenario depends importantly on the state of the credit markets. Given current credit market conditions, there's a risk that Fed rate cuts will not be as stimulative as they otherwise would be. Levels that are stimulative when the financial system is in good working order can actually end up being contractionary when it isn't. Memo to Ben: Even though the credit markets will benefit by getting past the typical year-end funding weirdness and by the various attempts at fiscal aid, the real system cleanser will be for you to get your brood on the same page.

The key is to get credit flowing again. Banks are currently facing liquidity problems as global deleveraging forces loans to be reintermediated back onto their balance sheets. I find it amazing that traditional banking institutions had successfully made the transition from lenders to originators, only to find the mortgages back on their balance sheets thanks to their insatiable quest for the last little fee. We've seen this game before (think early 1990s) and the end result will be the same: a significant steepening of the yield curve.

The world's banking system is evolving. However the brave new credit world unfolds, peaking volatility, monetary reflation and steeper global yield curves present opportunities for credit market participants of all stripes. Let's hope well-intentioned attempts at central bank transparency don't muck it up.

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