The Fed Should Care About Asset Prices

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When financial market bubbles burst the power of monetary policy extends well beyond its money creation capacity. Collapsing the risk-free rate reflates asset prices, restores positive net worth to banks, and thereby rescues economies in decline. But we must respectfully disagree with Fed Chairman Greenspan’s assertion that after-the-bust policy moves are all one needs to contemplate for asset prices. Japan made monetary policy errors in the aftermath of the 1990 bubble burst. But the gravest error they committed was in allowing the bubble to reach such colossal proportions. Beyond a certain point, monetary policy cannot put Humpty-Dumpty back together.

The U.S. Credit Crunch Versus Japan’s Burst Bubble

In the late 1980s success led to excess in the U.S. junk bond market. When price inflation pressures led the Fed to raise interest rates, junk bond prices fell by about 50%. The Fed, however, was able to put most asset prices back to pre-crash levels as it drove the risk-free rate from 5% to zero, in real terms. In Japan, when the Nikkei hit 40,000 and PE’s were at 100, the land around the emperor’s palace was said to be worth more than the state of California. What we should have known then, and certainly know now, is that no amount of interest rate decline was able put asset prices in Japan back to 1990 levels.

How does this asset reflation process operate? At the peak, exuberant investors expect spectacular earnings and price assets expensively, notwithstanding high risk-free rates. After crunch time, investors are skeptics. They discount the present value of a stream of earnings they assume to be meager, and they assign sharply lower values to asset prices. Enter the Fed. An asset worth 50 cents on the dollar at 10% Fed funds is worth par at 3% Fed funds. The meager steam of earnings is worth substantially more in a sharply lower interest rate environment.

Beyond a certain point of excess, however, the Fed loses its power to reflate. A building whose price falls by 90% fails to return to peak price even after short rates go from 8% to zero. And for Japanese banks, after eight years of ease, with interest rates at zero, they still required direct infusions of cash to get the left hand side of bank balance sheets to equal the right.

More generally, for an economy that experiences a wild excess in asset prices, the ability to right things with interest rate ease after the day of reckoning disappears. We do not believe that the U.S. equity market presents such a risk today. We simply feel compelled to point out that at some phantasmal level for asset prices, monetary policy loses its ability to put banks and other financial institutions back in the black.