Monetary Policy- The Course Changes Two Points To Port

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In my college economics courses, I was taught about the Liquidity Trap. It stated that if inflation gets too low or, you have deflation, borrowing money (i.e. the demand for money) can become so weak that economic activity declines. Milton Freidman championed the idea that it is the *real* interest rate that determines the demand for loans. The real interest rate is the nominal rate minus inflation. The Fed restricts credit by raising the nominal rate to five percent, for example, while inflation remains at two. This real interest rate of three percent discourages borrowing. During recessions the Fed typically lowers the nominal rate below the inflation rate, creating a negative real interest rate, stimulating the economy out of recession. At a low inflation rate or a negative inflation rate, this is no longer a viable policy option as there are no negative interest rates. The real rate remains high and therefore you are "trapped" in your economic weakness. The Japanese have experienced this problem over the last ten years in the first obvious Liquidity Trap example since the depression. The Japanese bout with deflation has gotten a lot of modern economists thinking.

During the 1970s while fighting the increasing inflation rate, it was common for an economist to state that the proper inflation target is zero, an assertion that the Fed agreed with. It was thought that any positive inflation had a tendency to accelerate the inflation rate and would perhaps occasionally get away from the Fed. Since inflation was always too high during the 1980s, no one bothered to debate what it should be. We were all on the same "fight inflation" page. For the past five years there has been a rising debate within the Fed regarding the optimal inflation rate. The new thinking is that the ideal inflation rate is positive but low. This enables the Fed to move short-term interest rates below the inflation rate and thus create cheap money to stimulate borrowing when needed. Bernanke, the new Fed chairman, has stated an "optimal" inflation rate of between one and two percent. This signals the official institutionalization of positive inflation in the United States as a goal and policy objective. An option for a real rate of minus two leaves the Fed open to all contingencies. Although we have had virtually no deflation since the 1930's, this makes it official. The implication on asset pricing, especially stocks versus bonds, is huge.

Recently, the IBES/ Fed model of stock values versus bond values has come under fire. The model compares the rate of return on the ten-year government bond with the earnings yield of the S&P 500, using a forward twelve-month earnings estimate. Historically, the return on earnings to the companies has been roughly the same as this ten-year interest rate (see figure one). The criticism has been that although the correlation between stock earnings yields and bond yields have been tight for twenty-five years, before this period history has been quite different. This is especially true if one looks before 1960.

Through the 1800s, earnings yields on stocks not only exceeded the ten-year government, but even the dividend yield was way above the bond yield at times. Why were equities so cheap versus bonds?

The gold standard had the effect of drawing the inflation rate of a currency towards zero. While on the gold standard, the U.S. would go through periods of deflation and inflation. Periods of deflation threatened nominal earnings and dividends. Stock market panics would decrease stock prices severely. Dividends would be cut as nominal growth in businesses would be negative during deflationary periods. Coupon rates of government bonds were stable since they were set at issuance. This created an additional rate of return above the coupon rate during deflationary times. Under these conditions it is logical for stocks to yield more than bonds, and so they sometimes did.

Now we are in a permanent inflationary world where we are off the gold standard. Bond coupons will loose their real value to some extent every year. Corporations with no real growth will slowly grow earnings in nominal terms over time. What this means is that the relevant time period for the current IBES/Fed model is only after we went off the gold standard and the markets have had some time to adjust accordingly. The twenty-five year picture of bond yields versus stock earnings yields is the exact period to look at the variances in pricing of this model. In fact, it is the only relevant period.

The implication is that stocks are indeed as cheap versus bonds as the model proposes. This is not to say that the gap between stocks and bonds cannot be closed by a decline in bond prices relative to stocks as opposed to stocks rising dramatically. In fact, the gap will probably be closed by both a rise in stock prices and a decline in bond prices. For these reasons, we believe that the beginning of Bernanke's reign over the Fed represents an excellent time to invest in equities.

Figure 1: