Bubbles Blow Away

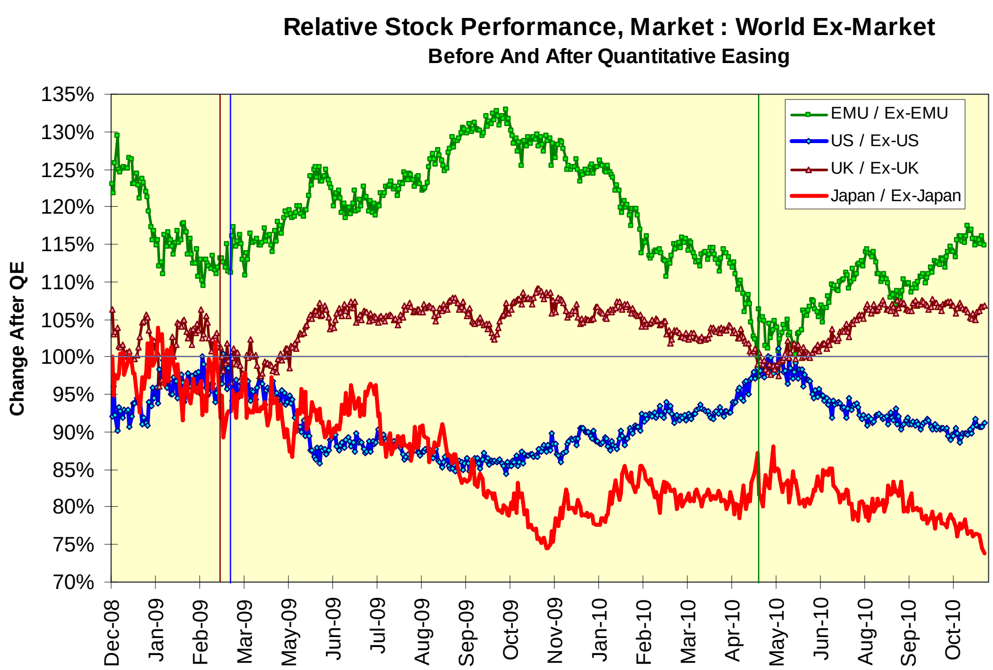
One of the reasons we have sayings such as "keep your enemies close and your friends closer" is your enemies' motives are easy to understand, but your friends often sugarcoat their comments to you. This is why I can appreciate Ben Bernanke's op-ed piece in *The Washington Post* published the day after the FOMC put another $600 billion on Uncle Sam's debit card: He came out and in unmistakably clear terms told us their objective was to create a bubble.

Whew; for a minute I thought I was the only one who could not find deflation on a dare or who did not believe for a minute money printing could spur investment and employment. Bernanke is now on the record the same way Alan Greenspan put himself on the record in February 2004 exhorting homeowners to expose themselves to adjustable-rate mortgages with short-term rates about to rise and housing prices in what we now know to be in a bubble.

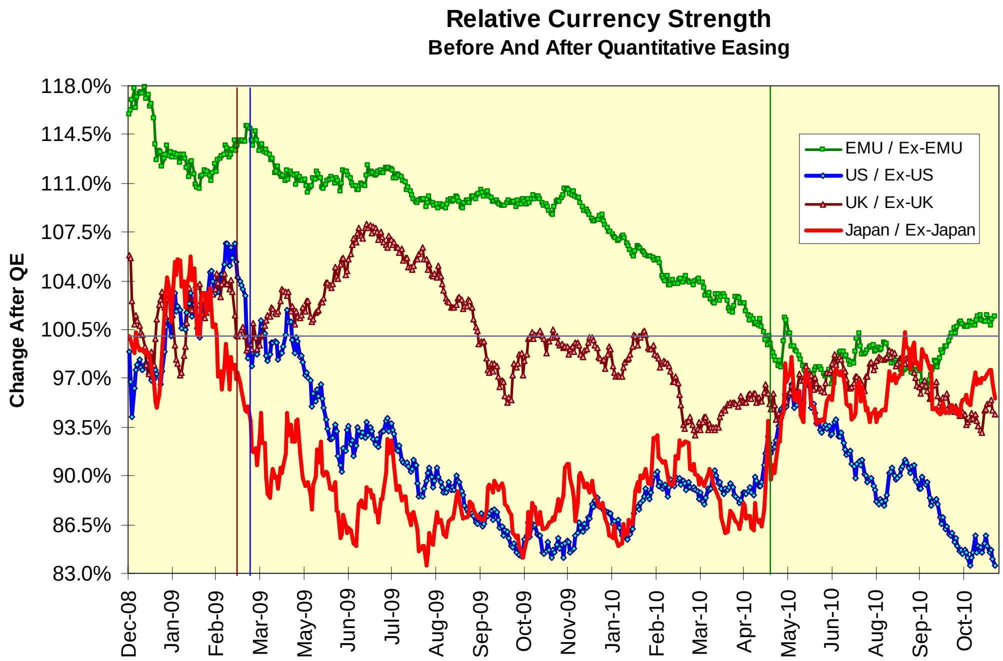
Aim Here, Hit There

The misdirection play works in football and the Three Stooges employed it in their pie-throwing scenes to achieve a look of surprise on some doyenne's face when the custard landed from an unexpected flight-path, but it really has no place in economic policy. If you want to stimulate the U.S. economy, there are perhaps between ways of doing it than lowering interest rates to stimulate American consumption to be satisfied by Chinese production or to devalue the dollar and convince all investors, American and foreign, to head elsewhere. I will predict the unemployed in this country who will face the inevitable inflation of this money-printing will find little joy in watching Indonesian stocks rise further.

The question of whose stock market returns you enhance with money-printing is a function of whether your currency is fuel for carry trades or not. If we re-index four markets' returns in USD terms against the world ex that market, e.g., the U.S. performance relative to the world ex the U.S. to the day prior to that country's quantitative easing, we see both the U.S. and Japan have underperformed the rest of the world while the U.K. and the Eurozone have outperformed. The colored vertical lines correspond to the start-dates of QE in each country, with Japan's start-date set at the left-hand axis.



We can repeat the exercise for currencies; here the dollar has taken it on the chin since March 2009 and appears ready to move lower. If you lower your rates toward 0%, print excess reserves and then tell people they do not have to worry about a national policy to prevent dollar erosion, they will take you at your word. The resulting dollar carry trade fuels gains elsewhere far more than it does in the U.S.



The end result of this is going to be the continued inflation of a bubble outside of the U.S. When the Federal Reserve says there is no inflation, they are looking in the wrong place: It is in asset prices outside of the U.S., to be followed by consumer prices outside of the U.S. to be followed, finally and violently, by higher inflation here. This policy will work as well as Greenspan's recommendations to take out an adjustable-rate mortgage did in 2004.