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## **Greenspan Attempts to Slowly Deflate the Equity Market Bubble**

Alan Greenspan has been concerned about US stock market valuations for years. Ever since his speech to the American Enterprise Institute in December 1996, global bourses have awaited with trepidation for the next bomb from the Fed chairman detailing the overvaluation of the US equity market. Recently, the “b” word (bubble) has even found its way into Mr. Greenspan’s lexicon. In his 22-July-1999 Humphrey Hawkins Testimony, the Fed chief intimated that a search for monetary policy initiatives that could deflate a bubble without bursting it was a high priority of the Federal Reserve Board.

This search is a work in progress. There is no question that Mr. Greenspan may very well be the most adept central banker in history at understanding how and why markets move, both from a fundamental perspective, as well as from a behavioral or technical frame of reference. His ability to mold an underlying latticework to the international asset markets has permitted the US Fed to stave off a possible financial market seize-up last year. Now, he must figure out how to deflate what he believes to be a dangerously over valued stock market without damaging the US and global economies.

While some commentators like to offer as a consolation the fact that after 1987, the US economy barely even blinked, the simple fact is that stocks are far more widely owned now than they were in 1987. While there are no exact statistics, anecdotal evidence indicates that more and more Americans are taking out home equity loans and borrowing against their 401K retirement plans to purchase stocks on margin. If there is a sudden loss of confidence in the economy, a occurrence that Greenspan stated has happened time and again in his speech this past Friday, a sudden and sharp move to lower risk assets could have a disproportionately negative affect on the US economy. This must be avoided at all costs.

It is clear that the Fed is spending a great deal of time attempting to evolve a strategy to slow up the market without crushing it. The first prong of attack was to suggest that if there is a bubble, that the Fed could possibly mitigate the blows by applying proper monetary policy, as stated in July’s Humphrey Hawkins testimony. The second prong was to raise the discount rate, while at the same time mollifying the markets with a dovish statement regarding expected future inflation. Unfortunately, the markets misinterpreted this move initially by assuming that the Fed was finished raising rates. While a further rate hike is unlikely this year, the discount rate move is a clarion call for further increases in the Federal funds rate during the year ahead. The discount rate would not have been nudged higher had the Fed thought there was any chance that the next move would be to ease rates.

The Fed is apparently hoping to manage the bond and stock markets by slowly moving rates higher, while at the same time indicating that the economy remains in balance. Increased borrowing costs will ultimately force market participants to lay off undue leverage as too costly, ultimately leading to a more demographically reasonable growth path. The hope is that this will lead the market to cool off via a trading range, or modest, drawn out decline.

While it is not clear that Alan Greenspan and the Fed can pull off such a gargantuan feat, his prowess at managing expectations and monetary policy is the last best chance to avoid writing a new chapter in Charles Mackay's classic tome, "*Extraordinary Popular Delusions and the Madness of Crowds*".

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