Agincourt Capital Management, LLC

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Investment Update

Even though it's mid-August, we'd like to make a recommendation for late summer reading: the recent book by former Federal Reserve Board Governor Laurence Meyer, "A Term at the Fed: An Insider's View." Admittedly, it's no heart-pounding Grisham page-turner; yet this book is a relatively entertaining account of Dr. Meyer's five and one-half years at the Fed.

As one of seven Fed Governors, Meyer held a permanent position on the Federal Open Market Committee (FOMC) the arm of the Fed charged with meeting the dual objectives of price stability and full employment. The FOMC's primary tool for achieving those goals is to set the appropriate level of that most crucial of US short-term rates, the Fed funds rate. Meyer's narrative gives a first-person account of the workings of the Fed, providing an insider's view of how decisions are made by this influential group of men and women. The period during which Dr. Meyer served the Fed included such events as the rise and fall of The New Economy, the Asian currency crisis, the meltdown of Long-Term Capital Management, the Y2K scare, the dot-com bubble, the 9/11 terrorist strikes and the recent recession as well as the early months of the current recovery. A busy period, indeed.

As the book begins with Dr. Meyer's first days at the Fed, we are immediately reminded of just how much the Fed changed during Meyer's tenure. When he became a Fed governor in 1996, the FOMC was still operating largely as a secret bureaucracy, a group that functioned much in the same way as it had for the previous 60 years, as if still clouded by the remnants of former Chairman Paul Volker's famous cigar smoke. In 1995, for the first time, the Fed began releasing a statement immediately following those FOMC meetings when a change in the Fed funds target was made. This brief statement, announcing the new target funds rate, represented a significant degree of openness for the tradition-bound Fed. You may recall that prior to this, investors had to watch the "open market" actions of the Fed and the level of Fed funds in the days following the FOMC meetings to see if the Fed had lowered or raised its target rate.

Meyer's very first FOMC meeting in June of 1996 turned out to be a momentous one, as Meyer relates how the discussion centered on the issues of inflation targeting and NAIRU. For those not familiar with the term, NAIRU is the non-accelerating inflation rate of unemployment—that's Fedspeak for the lowest rate of unemployment that can exist without causing inflation to rise. Below this level of unemployment, inflation will rise due to the wage pressures that come from the demand for labor exceeding its supply. In the summer of 1996 the FOMC was perplexed by the fact that while unemployment was falling, inflation was still declining; in short, NAIRU wasn't "working." Fed Chairman Greenspan had an explanation: productivity gains, from the massive investment in computer technology, was allowing companies to do more with fewer employees, easing the pressure on wages. Even though the measured data at the time showed no productivity gains, Greenspan had noticed a small discrepancy in the national income numbers that tipped him off.

The other main topic at this meeting was one the FOMC had been grappling with for some time—identifying an outright inflation target. The Fed's traditional goal of "price stability" was ill-defined; some committee members argued that it meant a rate of inflation of zero, while others were (rightfully) fearful of zero inflation, since at that level the Fed has no ability to stimulate the economy by lowering rates (e.g., at any inflation level below zero, "real" rates cannot be lowered into negative territory, as the Fed has occasionally done to stimulate the economy). After a lengthy discussion, the Committee finally agreed on a 2% "target" for inflation.

What came next is one for the Fed archives. Greenspan, perhaps fearful that the two new committee members might not appreciate the importance of "the highly confidential nature of what we talk about at an FOMC meeting" began the second day of this two-day FOMC meeting with an admonition, instructing all attendees to keep quiet about the inner dealings of the FOMC, including "the discussion we had yesterday [that] was exceptionally interesting and important. I will tell you that if the 2 percent inflation figure gets out of this room, it is going to create more problems for us than I think any of you might anticipate…it is very damaging to this institution when anybody conveys information…concerning what members of this group are thinking or what the FOMC is likely to do."

This was not the only time Meyer would be reminded to keep quiet about the FOMC's deliberations during his tenure at the Fed. To this day, committee members are prohibited from making speeches in both the week before and after an FOMC meeting. In fact, despite constant invitations to speak, FOMC members make few public speeches, and when they do, they must show remarkable restraint in their remarks. Any commentary on the economy must be clearly stated as "personal opinion" and not the official position of the FOMC. Only the Chairman is entitled to speak on behalf of the FOMC, and even then, he is known for his indirect (some would say incomprehensible) style.

The reason for all this cloak and dagger stuff is simple: Since the FOMC's actions can move the markets, any significant prior insight into the Fed's thoughts can be worth a lot of money. As the Chairman of the Federal Reserve and the FOMC, Greenspan maintains strict control over what he wants the investing public to know about the Fed's thinking and its plans. If there's going to be a leak, Greenspan wants to be the guy doing the leaking.

As mentioned earlier, during Meyer's tenure, the Fed became much more forthcoming with the post-FOMC meeting statements (officially known as the "Press Release"). Beginning in May 1999, the FOMC began making additional disclosures (not just an announcement of a change in the Fed funds rate) on those occasions when the committee made a significant change to its forecast of future conditions. This periodic policy "bias" statement was short-lived, however, as investors and commentators tended to read too much into the statement—for instance, if the FOMC stated that the economy was biased toward economic weakness, the markets assumed a cut in the Fed funds rate was a certainty. What was intended as way to communicate the Fed's thoughts to the public quickly turned into an exercise in painting themselves into a corner.

After studying the issue, the Fed decided in early 2000 to release a statement after *every* FOMC meeting, a statement that would address the committee's assessment of the risks in the US economy. Specifically, this statement would indicate whether the risks were balanced or tilted in one direction or the other as to either growth or price stability. This "format" was refined further last year (after Meyer's departure) to separately address growth and prices.

Of course, the star of the book, and the center of the US monetary universe over the past 17 years is Alan Greenspan—a brilliant man and a remarkably strong leader who, if we are to believe Dr. Meyer, had the respect of all who served with him. Famously private, Greenspan spent little time outside of formal FOMC meetings interacting with other committee members, but Meyer believes this was done for good reason: Greenspan wants his colleagues on the FOMC to develop independent opinions of the important monetary issues of the day. At the same time, Greenspan makes his opinions known to the other FOMC members, either through his public testimony before Congress or in the case of the Governors, in their pre-meeting the Monday before each FOMC meeting. This allows members to be able to freely form their opinions, but at the same time work towards a consensus at the meetings.

Speaking of the FOMC meetings, the book offers more surprises: Evidently, Greenspan writes the Press Release *before* the meeting. During the FOMC meetings, he allows each FOMC member (and Federal Reserve Bank President) to make a short presentation before offering his own assessment. When the members vote on where the Fed funds target should be, and what the assessment of the risks is, it is understood that the vote should be unanimous. Occasionally, one member may vote against the Chairman, and in rare instances two members have opposed the action and/or the statement. In Meyer's words, "A third, however, would be viewed as a sign that the FOMC is in open revolt with the Chairman's leadership. The dissents, rather than the policy decision itself, would become the story."

Other little surprises from this book include:

> By and large, the Fed Governors and Presidents were out of the loop regarding the New York Fed's negotiations with banks to bail out Long-Term Capital Management. Meyer received most of his information from reporters.
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> While acknowledging the equity bubble, Meyer wonders how much the Fed could have done to prevent it. In our opinion, he loses a little credibility when he trots out the old 'you can only identify a bubble after it bursts' song-and-dance. One would have thought the S&P 500's P/E of 45 would have tipped you off, Larry.
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> Increased productivity, Greenspan's explanation for the violation of the NAIRU principal in the late 1990's, didn't begin to show significant measured gains until late 1998, two and one-half years after Greenspan began talking about it, with little evidence to support him, to the FOMC. Retro-active revisions made in 1999 and 2000, however proved that the Chairman was dead right: the revised government figures showed that the productivity gains actually began in late 1995, a few months before Greenspan discovered a discrepancy in the GDP data that first made him think about productivity.

One last point: if your appetite is whetted by the Meyer book, and detail is your "bag," the Fed's website has transcripts (yes, word-for-word transcripts) of every FOMC meeting from 1979-1998 (they are released with a five-year lag). But be warned: the G. William Miller era is not for the faint of heart!