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Research Note

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Recent Bernanke Speech Addresses Concept of "Too Big to Fail" and Other Economic Challenges

In a recent speech to the 406th meeting of the Economic Club of New York, at which members of Segal Advisors were in attendance, keynote speaker Federal Reserve Chairman Ben S. Bernanke spoke about the Federal Reserve's outlook for the U.S. economy and the challenges the economy faces going forward. In addition, he addressed questions about domestic financial institutions, asset prices and the value of the dollar. This issue of *Research Note* summarizes Chairman Bernanke's key comments.

Outlook for the U.S. Economy and Policy

Chairman Bernanke began his speech by comparing the current state of the U.S. economy to its state one year ago, indicating that "today, financial conditions are significantly better off than they were [a year ago], but significant economic challenges remain." He believes that the actions taken by policymakers during the fall of 2008 were critical in stabilizing the economy and providing the foundation for recovery. Chairman Bernanke cited U.S. Gross Domestic Product (+3.5 percent for the third quarter of 2009) as evidence of this recovery but warned that "how the economy will evolve in 2010 and beyond is less certain." He noted that government programs such as "cash for clunkers" contributed to the economic growth.

He spoke at length about two headwinds that may prevent the expansion from being as strong as desired: constrained bank lending and the difficult job market. Both subjects are discussed in the following sections.

Constrained Bank Lending and Credit Availability

During the fall of 2008, the Federal Reserve created new lending programs in order to support credit markets. While many of these policy actions were able to improve the functioning of short-term funding markets, access to credit is still difficult for borrowers, namely households and small businesses. Chairman Bernanke cited three primary reasons for constrained credit markets:

- Banks are now holding more liquid assets because of the impairment of bank funding markets.
- High loan losses and uncertainty regarding how capital requirements may change are resulting in banks being more conservative in their lending standards.
- Many securitization markets remain impaired, which reduces an important source of funding for banks that previously benefitted from packaging mortgages and other asset-backed debt for resale. This, in turn, freed up funds for the purpose of making other investments.

Chairman Bernanke stated that the Federal Reserve will continue to work with banks to ensure that creditworthy borrowers have access to credit. To that point, the Federal Reserve continues to facilitate securitization through the Term Asset-Backed Securities Loan Facility (TALF) program and support residential home lending through purchases of mortgage-backed securities.

While discussing headwinds posed by constrained bank lending, Chairman Bernanke also commented on the commercial real estate (CRE) market. He highlighted that weakening fundamentals within the commercial real estate sector resulted in a deterioration in the quality of CRE loans on bank balance sheets. The Federal Reserve recognizes the importance of the CRE sector in the economic recovery and extended the TALF program for existing commercial mortgage-backed securities (CMBS) through March 2010 and new CMBS through June 2010.

Difficult Job Market

As highlighted in the September 2009 issue of Segal Advisors' *Research Note,*[1] the decline in jobs and increase in the unemployment rate during the current recession has been more severe than in any other recession since World War II. Chairman Bernanke also cited part-time employment and average workweek data, which suggest that the slack within the labor market is worse than indicated by the unemployment rate.

Chairman Bernanke stated that the "natural question" is whether the U.S. will experience a jobless recovery in which output grows but employment does not increase (translating into a period of productivity growth). Currently, productivity growth has been high, which "generally reflected a pronounced declined in labor input rather than labor output." He said that over time, employers may find

[1] This issue, "Digging Deeper into Labor Market Data," is on the following page of Segal Advisors' Web site: http://www.segaladvisors.com/publications/sept09RN.pdf

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their labor force stretched and need to add workers. However, firms are still under pressure to cut costs and improve efficiency. He concluded that employment gains may be modest during the early stages of expansion.

Policy Outlook

Chairman Bernanke expects moderate growth to continue in 2010, as signs emerge of strengthening final demand (an estimate of consumer spending), inventory production, residential investment, manufacturing activity, and business spending. While there are two significant headwinds facing the U.S. economy (as discussed above), Chairman Bernanke believes these situations will normalize gradually. In addition, he addressed the following topics:

- ***Inflation*** Chairman Bernanke stated that longer term inflation expectations are stable and inflation "seems likely to remain subdued for some time."
- ***Value of the Dollar*** While the Federal Reserve does not typically comment on the state of foreign exchange values, Chairman Bernanke highlighted that, as the functioning of global markets has improved, "safe haven flows have abated," and the dollar has lost its gains from 2008. He stated that the Federal Reserve will "continue to monitor these developments closely" and formulate policy that fulfills its duel mandate of full employment and price stability.
- ***"Too Big to Fail"*** Chairman Bernanke said that the concept of "too big to fail" must be addressed, as it is unacceptable that the government had to bail out financial institutions in order to prevent a collapse of the U.S. economy. He said the policymakers must focus on the creation of "freedom to fail" and an alternative to bankruptcy and bailouts for financial institutions.
- ***Asset Prices*** Chairman Bernanke stated that it "is inherently difficult to know whether an asset's price is in line with its fundamental value." He commented that it is not obvious that there are any large dislocations currently in the U.S. financial system but the "best approach" is to utilize policy actions to restrain "undue risk-taking."

"Policymakers must focus on the creation of 'freedom to fail' and an alternative to bankruptcy and bailouts for financial institutions."

Bernanke's Conclusion

Chairman Bernanke ended his remarks by stating that the low Fed funds rate is likely to continue for an extended period; however, any significant change in economic conditions or outlook would result in a change in policy outlook. He reiterated that the Federal Reserve has "a wide range of tools for removing monetary policy accommodation when the economy outlook requires [them] to do so."[2]

Implications for Institutional Investors

The topics Chairman Bernanke addressed in his speech echoed subject areas and key themes discussed in prior issues of *Research Note* and *Synopsis*, Segal Advisors' quarterly publication. In particular, that the employment situation remains critical to establishing a period of persistent recovery and economic growth. Headwinds clearly remain that may hamper recovery as tight credit for small businesses and consumers may dampen prospects in the near term. Institutional investors should consider the impact of slower domestic growth on projections for asset growth.

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For advice on how the trends discussed may affect your investment program, please contact your Segal Advisors consultant, George Kiriakos (212.251.5219 or gkiriakos@segaladvisors.com) or Bridget McKenna (212.251.5201 or bmckenna@segaladvisors.com).

[2] The text of Chairman Bernanke's speech is available on the following page of the Federal Reserve's Web site: http://www.federalreserve.gov/newsevents/speech/bernanke20091116a.htm

***Research Note* is prepared by Segal Advisors' research team. To receive future issues of *Research Note* and other Segal Advisors publications as soon as they are available online, register your e-mail address via the Segal Advisors Web site: www.segaladvisors.com**

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