

# Bernanke Gets an Economics Lesson

June 8, 2009

"The Treasury is issuing debt and the central bank is buying it. It gives the alarming impression that the U.S. one day might begin to meet its financial obligations by simply printing money. And we all know what happens to a country that chooses to monetize its debt – it gets runaway inflation and a gradual erosion of workers' paychecks and family savings."

– Rep. Paul Ryan (R- WI)

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Continued weakness in long-term U.S. Treasury securities took center stage last week. The Federal Reserve, the Treasury and Congress each weighed in. Unsurprisingly, there was no shortage of finger pointing as each sought to shift responsibility onto others or into the future.

Fed Chairman Ben Bernanke faced his share of criticism during testimony before the House Budget Committee. Representative Paul Ryan, the top Republican on the panel, pointed to rising Treasury-bond yields as evidence that investors are becoming concerned about mounting federal debt levels and inflation. "This is the bond market telling us that there is no free lunch," Ryan said.

Though very true, Ryan's remarks seemed no less politically calculated than those of anyone else in Washington. His remedial lessons for Bernanke in basic economics were in effect a partisan attack on the Fed's credibility and independence. The implication was that the Fed has bowed to political pressure from a Democratic administration.

For his part, Bernanke sidestepped the issue of Fed culpability and instead blamed the nation's fiscal predicament on a lack of political will among elected officials. "Addressing the country's fiscal problems will require a willingness to make difficult choices," Bernanke said. "In the end, the fundamental decision that the Congress, the administration, and the American people must confront is how large a share of the nation's economic resources to devote to federal government programs, including entitlement programs."

Bernanke continued his tough talk. In response to a question, he implied there might be limits to how far the Fed would be willing to go in using its printing press to finance Congressional spending. "Either cuts in spending or increases in taxes will be necessary to stabilize the fiscal situation," Bernanke warned. "The Federal Reserve will not monetize the debt." Observers began to wonder whether Bernanke had misspoken, or whether hell in fact had frozen over.

Just as important was Bernanke's warning that lasting economic recovery cannot take root until budget deficits are brought under control. "Clearly, the Congress and the administration face formidable near-term challenges that must be addressed," Bernanke said. "But those near-term challenges must not be allowed to hinder timely consideration of the steps needed to address fiscal imbalances. **Unless we demonstrate a strong commitment to fiscal sustainability in the longer term, we will have neither financial stability nor healthy economic growth.**"

On this last point Bernanke clearly agreed with Ryan that there is no free lunch, as soaring interest rates would frustrate any U.S. attempts to spend its way out of its economic problems. That said, the chairman has done little during his tenure to enhance Fed credibility. If Bernanke wants to talk like Dirty Harry, then he is going to have to stop acting like Barney Fife.

## Geithner Laughed at in China

The most bizarre episode in last week's drama unfolded in the Far East. Anxiety in China over U.S. policy apparently had grown so acute that Treasury Secretary Timothy Geithner was dispatched with hat in hand to plead for continued Chinese support. With nothing concrete to offer in the way of assurances, he instead resorted to bland platitudes, wishful thinking and fanciful dreams. "Chinese assets are very safe," Geithner said while speaking at Peking University. The statement reportedly was met with loud laughter from the audience of students.

One problem with Geithner's pitch was that its fiscal-discipline component was predicated upon U.S. economic recovery. "We are very committed to make sure that **when recovery is established, that we go back to living within our means, that we bring our fiscal deficits down to a sustainable level**, that we unwind and reverse these exceptional measures that we've taken in the financial sector," Geithner said in an interview with Chinese state television. However, Chairman Bernanke testified that it has to be the other way around: "commitment to fiscal sustainability," as he put it, must be "demonstrated" before recovery can occur. If that's the case, then Geithner's assurances are meaningless. Either Bernanke deliberately undercut Geithner, or this is an instance of two people unable to get their stories aligned.

## The Picture



Charts courtesy of [StockCharts.com](http://StockCharts.com)

Last week's less-than-stellar performances from our public officials did little to reassure the bond market, as escalating federal debt and increased inflation expectations continued to weigh on prices. Nevertheless, on a price basis the 30-year U.S. Treasury remains above its 52-week lows as shown in the chart above. Support should materialize near 112½, with further support at 110. The Treasury-bond market appears to be in or nearing capitulation, and the panic selling could exhaust at any time.

On the next page is the S&P 500 daily chart. The index pushed through its 200-day simple moving average last week and is testing important resistance in the 944-950 area. Major resistance is at 1008 and should prove very strong. Key support is at 875-880, with near-term support at 925 and 914.

Momentum has weakened, but remains positive. RSI continues to hold above the important level of 50, while MACD made a bullish moving-average crossover last Monday and remains above its zero line. Even so, both measures have failed to confirm the index's most recent highs.

Price-volume behavior continues to be the weakest aspect of market action. This is a characteristic feature of countertrend moves. Volume itself has dried up considerably, and On-Balance Volume may be in the process of generating a negative divergence.

The shallowness of the selloffs during this rally indicates that buyers have been coming in at the first sign of weakness. This could be setting up a buying panic that exhausts the buyers and ends the rally. At these elevated levels risk is high and caution is warranted.

**\$SPX (S&P 500 Large Cap Index) INDX**

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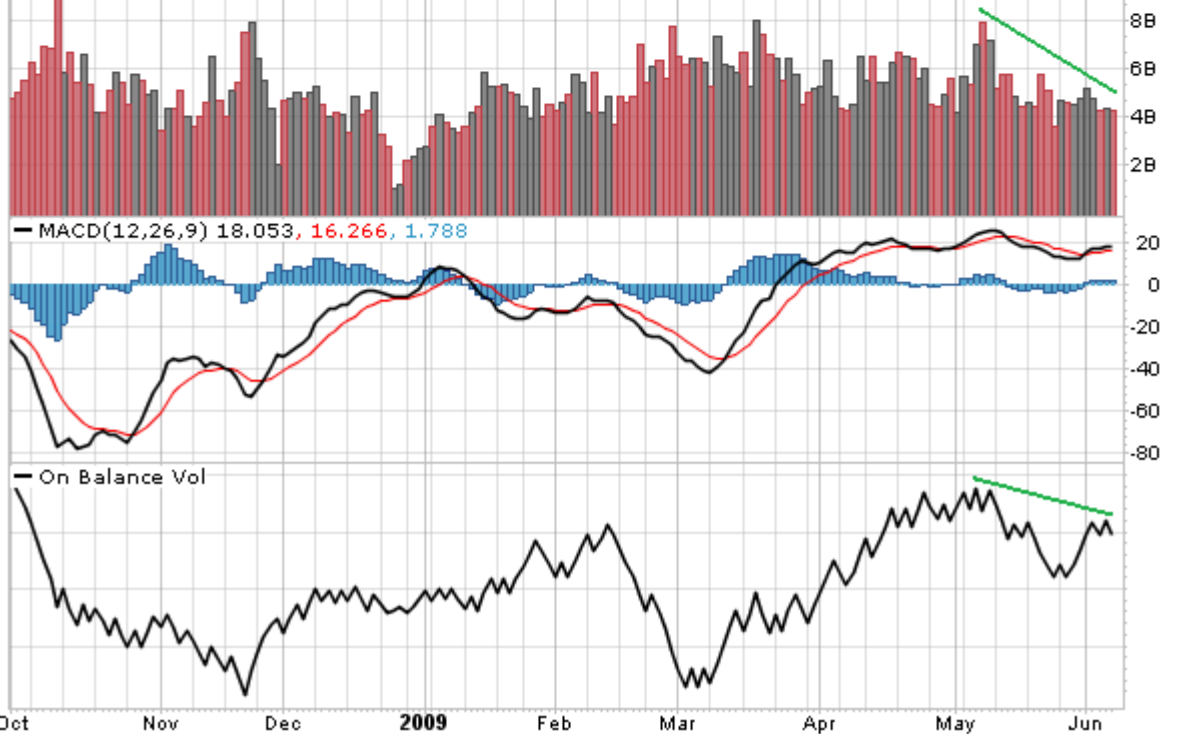
5-Jun-2009

**Open 945.67 High 951.89 Low 934.13 Close 940.09 Volume 4.3B Chg -2.37 (-0.25%)**

**▲ RSI(14) 61.33**



**Volume 4,254,776,832**



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