Federal Reserve Chairman Ben S. Bernanke is trying to inject a little of the exuberance his predecessor Alan Greenspan called “irrational” into markets for everything from stocks to housing.

Bernanke, who is seeking to spur the economy with a third round of so-called quantitative easing, has said his stimulus works by lowering borrowing costs and encouraging investors to seek higher-yielding assets. Boosting home and equity prices through bond buying will encourage consumers and businesses to spend more, according to Bernanke.

Since these are the same assets that plummeted during the financial crisis after reaching record highs, “is there some risk you could start a new bubble and repeat the whole cycle? I suppose there is,” said Robert Shiller, the Yale University professor who forecast the end of the Internet boom in his book, “Irrational Exuberance,” which was published in March 2000, the month the Nasdaq Composite Index peaked before crashing 78 percent.

Bernanke's approach risks “distorting” decisions, and “it might be economically inefficient to try to push prices up so much,” Shiller, who also predicted the bursting of the subprime-mortgage bubble, said in a New York interview Oct. 15.

While Federal Reserve Bank of New York President William C. Dudley acknowledged that current policy “could distort asset allocations and lead to renewed financial-asset bubbles,” this isn’t a risk now, he said in an Oct. 15 speech.

‘Little Evidence’

“There is little evidence of problems or excesses, but this could change as the recovery proceeds,” said Dudley, who is also vice chairman of the policy-setting Federal Open Market Committee.

If these risks climb, they will need to be factored into the committee’s decisions, and Fed officials will “examine what steps could be taken on the macro-prudential front in response,” he said.

In answering audience questions, Dudley said the Fed’s policies are affecting yields in the bond market, though “to say that’s a bubble, I don’t think that’s quite right.” He added that the debt market is a “lever of policy” for the central bank. The Fed’s asset purchases helped drive yields on the benchmark 10-year Treasury note to a record low of 1.38 percent on July 25. The yield was 1.81 percent on Oct. 22.

The Standard & Poor's 500 Index reached 1,465.77, the highest since 2007, on Sept. 14, the day after the FOMC said it would buy $40 billion of mortgage-backed bonds a month without limiting the total or duration of purchases. The index is up 112 percent (SPX) since hitting a nadir in March 2009.

Home Prices

Home prices also have begun to rise, jumping in the second quarter by the most in more than six years, according to the S&P/Case-Shiller index, a real-estate benchmark of property values in 20 cities that Shiller created with Karl Case, a professor emeritus at Wellesley College in Massachusetts.

Fed policy makers are meeting today and tomorrow in Washington.

The Fed’s large-scale asset purchases probably will lift stocks by 3 percent in the two years following the Sept. 13 announcement of QE3, as low yields on government bonds push investors into riskier assets, according to a Sept. 27 report by Deutsche Bank AG economists. They also estimate the new stimulus will lift home prices by 2 percent in the same period, assuming the Fed maintains purchases of Treasuries and mortgage debt through 2013.

Perfect Knowledge
“How do they know whether or not these prices will prove to be justified in the long run?” said John Lonski, chief economist at Moody’s Capital Markets Group in New York. “The Fed doesn’t have perfect knowledge about what constitutes a sound long-term price for equities or housing, but this is a risk the Fed is willing to take.”

Lonski said potentially inflated asset prices could prove “devastating” if the Fed is forced to tighten policy quickly or mistimes its exit from record monetary stimulus. The Fed has had “less than perfect” timing in the past, he said.

Greenspan’s “irrational exuberance” comment in 1996 wasn’t actually timely: When he spoke, the Dow Jones Industrial Average was above 6,400. It peaked at over 11,700 in January 2000, before technology stocks crashed. In May of this year, Greenspan said stocks are “very cheap” and likely to rise. The Dow was 13,345.89 at 4 p.m. Oct. 22.

Blame Greenspan

Critics blame Greenspan for inflating the housing bubble by holding the Fed’s benchmark interest rate too low for too long, slashing it to 1 percent in late June 2003 and keeping it there for a year.

Bernanke has relied on unorthodox stimulus such as quantitative easing to reduce borrowing costs after cutting the federal funds rate to near zero in December 2008. The latest steps have succeeded in making home mortgages less expensive, with the average fixed rate offered on new 30-year loans at 3.47 percent on Oct. 19, down from 3.57 percent Sept. 12, the day before the last FOMC meeting, according to Bankrate.com data.

QE3 is designed to boost “Main Street,” the Fed chairman said at a Sept. 13 press conference after the Fed announced the measure. “Many people own stocks directly or indirectly,” Bernanke said. “The issue here is whether or not improving asset prices generally will make people more willing to spend.”

The S&P 500 has risen 1.9 percent since Bernanke set the stage for a third round of bond buying in an Aug. 31 speech in Jackson Hole, Wyoming.

‘Underrated Effect’

Allen Sinai, president and chief executive officer of Decision Economics Inc. in New York, says the stock-market effect is “underrated.” He estimates that a 20 percent gain in the S&P 500 can add as much as 1 percentage point to U.S. growth with a one- to two-year lag.

The Fed’s third round of quantitative easing could be more powerful for stock prices than previous rounds because the open-ended policy is contingent on higher employment and stronger economic growth, assuring better earnings, he said.

“It is as if the Federal Reserve has promised to keep on reducing the federal funds rate until the economy grows at a higher rate,” Sinai said. Persistent Fed stimulus means “I can expect stronger growth, and stronger growth should mean higher earnings, and I can buy stocks.”

Fed Governor Jeremy Stein questioned in an Oct. 11 speech whether companies would take advantage of record-low borrowing costs to invest in equipment and software or simply buy back stock and pay dividends.

Record Low

Investment-grade corporate bonds with an average maturity of more than 10 years yielded a record low 2.76 percent on Oct. 15, according to index data compiled by Bank of America Merrill Lynch. Investment-grade issuance in the U.S. has topped $900 billion in 2012, already exceeding all of last year’s borrowing, data compiled by Bloomberg show.

As corporate bond yields fell and issuance rose, total dividend payments jumped to $275.8 billion in the four quarters ending Sept. 2012 compared with $247.3 billion in the previous four quarters, according to data gleaned from Securities and Exchange Commission filings by FactSet, a data-analysis company in Norwalk, Connecticut.

Stein also said the possibility that Fed policies are causing banks, insurance companies and pension funds to take on more risk as they try for higher returns “should be taken very seriously.”

“A short summary would be that there is some qualitative evidence of reaching-for-yield behavior in certain segments of the
market but that we are not seeing anything quantitatively alarming at this point,” Stein said. “The worry is that one often sees only the tip of the iceberg in these kinds of situations, so one needs to be cautious in interpreting the data.”

**Falling Yields**

Yields on high-yield, high-risk securities also have fallen, to a record low of 6.84 percent on Oct. 18, Bank of America Merrill Lynch index data show.

If Fed policy makers “just keep buying assets, the price of assets will go up in a big way because they want to do a huge amount every month,” said Jagdish Bhagwati, a professor of economics at Columbia University in New York whose former students include European Central Bank President Mario Draghi and International Monetary Fund Chief Economist Olivier Blanchard.

“That also has a downside because it can lead to a bubble; that's exactly what we should be worried about,” Bhagwati said. “Creating bubbles is not a risk-free thing.”

To contact the reporters on this story: Caroline Salas Gage in New York at esalas1@bloomberg.net; Jeff Kearns in Washington at jkearns3@bloomberg.net

To contact the editor responsible for this story: Chris Wellisz at cwellisz@bloomberg.net