Global Financial
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Has The Fed Lost Its Credibility?

SYNOPSIS

- The Fed once again chose to keep interest rates at current levels, which is frustrating given how far we have come since the depths of the financial crisis.
- Unemployment and inflation have dramatically improved, so many investors were expecting to see the Fed adjust interest rates accordingly throughout the year.
- Although the Fed has destroyed much of its credibility, their decision to keep artificially low interest rates will not cause any major issues in the economy.

KICKING THE CAN

This week was a big one for central banks across the world. Most notably, the Federal Reserve (Fed) announced that they are keeping interest rates at current levels rather than move them higher to reflect the continued growth in the economy.

Back in December, the Fed raised interest rates for the first time in a decade and projected four additional hikes in 2016. As of this week, we have yet to see a single rate hike this year, and many feel that the Fed changing its tune is a sign that our economy has reversed course.

I strongly disagree, but before I give my opinion as to why the Fed has failed to act, it is important to understand why the Fed controls interest rates and analyze the data they use to assess the overall health of the economy.

THE FED'S GOAL

Think of a central bank as a bank for big banks. For example, Bank of America and J.P. Morgan are "customers" of the Federal Reserve in a similar way that we are customers to them.

We use banks to deposit paychecks and take out loans to buy houses and cars, and these large banks rely upon the Fed for similar needs. Big banks use central banks to hold excess cash and take out loans periodically to help support their business.

The Fed has a dual mandate that consists of (1) controlling inflation and (2) maximizing employment. The combination of these two should theoretically produce manageable growth, where consumers make more and spend more without inflation going haywire. Their primary tool to achieve such harmony is through adjusting our access to money.

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Consider how most consumers buy expensive goods and assets. Rarely do we pay for homes, cars, and other big-ticket items in cash. Instead, we take out loans and then pay back these debts over time. Since big purchases are mostly done on credit, interest rates are the blood of our economy.

Meaning, if the mortgage rate rises from 4% to 10%, house sales will probably get hit because fewer consumers can afford to pay a higher interest rate on a large loan balance. Control interest rate levels and you control how fast/slow an economy can grow (in theory).

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The Fed's primary means of controlling interest rates on loans is by the altering the deposit rate they pay big banks and the interest rate on loans made to them. If the Fed wants to slow down the economy to combat rising inflation, they increase these rates, which will (1) incent banks to earn a higher deposit rate, and (2) make loans to banks more expensive and subsequently less attractive.

More big bank cash will be deposited at the Fed, which will decrease the supply of money available to bank customers for loans. The rise in the cost of a loan to a big bank will also be passed along to consumers, which slows down the economy.

***NOTE**: This situation is no different than any other industry that can pass along price increases to its customers. If a gas station is forced to pay more for fuel due to rising oil prices, they will increase the price at the pump to maintain profitability. Banks effectively do the same.*

On the flip side, when the Fed wants to encourage economic growth, they will lower both the rate they pay big banks on deposits and loans made to them. Big banks will then withdraw money from the Fed and seek higher returns by loaning to their customers. The rise in the amount of money available for loans causes the price of a loan to fall. More attractive loan rates lead to more buying, which pushes economic growth higher.

In summary, these interest rates charged by the Fed to big banks are the primary tool for a central bank to control economic growth

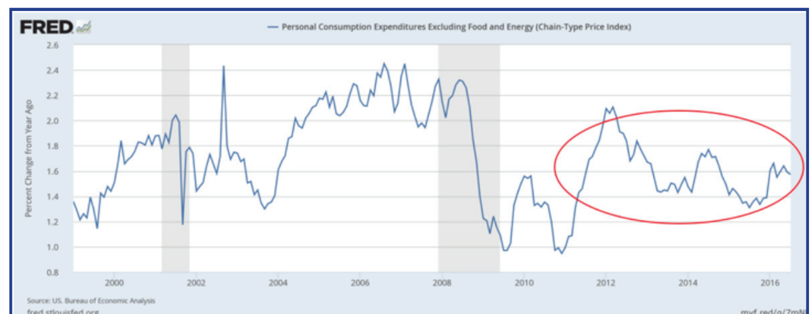
THEY MET THEIR GOAL

During the depths of the financial crisis, the Fed moved interest rates down to zero to prevent our economy from falling into a depression (per above, low interest rates should incent people to take out loans to buy expensive goods and help our economy recover).

The question to answer today is if our economy continues to warrant a similar policy as the one used during the worst economic crisis since the Great Depression. Since the Fed focuses primarily on inflation and unemployment, let's see how we are doing on both fronts.

The Fed aims for a "Goldilocks" level of 2.0% inflation because this level allows for enough inflation to keep wages rising but not enough to cause damage. Once inflation approaches the 2.5% - 3.0% range, they will tighten the screws to prevent long-term risk to our economy.

The chart below shows the core inflation rate since 1999, which excludes food and energy since these two components are often very volatile and can create a lot of "noise" when observing economic data.



Inflation fell off a cliff during the financial crisis, and although it's been somewhat volatile since then, the red circle shows that the Fed has mostly achieved its first goal.

In regards to employment, the chart below shows the unemployment rate since 1999.

The red arrow indicates that not only has the unemployment rate fallen, it's currently sitting near all-time lows.

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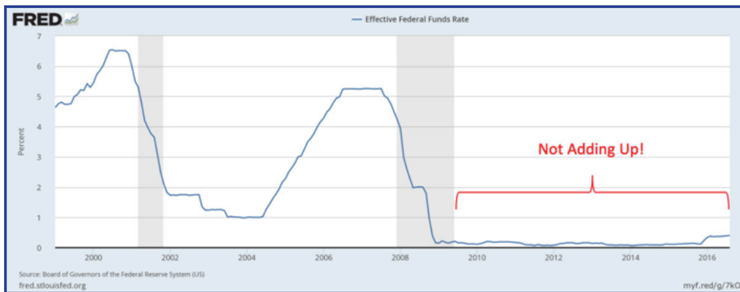
***NOTE**: NOTE: A complete analysis would require aggregating much more economic data, but for purposes of this discussion, we only need to observe the broader trends.*

Combine rising inflation with falling unemployment rate as we progress back to a healthier economy, and one would assume that the Fed should have already claimed victory and adjusted interest rates accordingly. However, the chart below shows just the opposite.



Despite the improving fundamentals and achieving its original goal, the Fed has only raised interest rates by a quarter of one percent – a minuscule amount. This decision is truly perplexing, but what's even more baffling are their excuses for staying the current course this year.

First, it was global volatility ignited by concerns over China, then it was oil prices falling (ironically a phenomenal benefit for our economy), then came a few weak economic data points, then Brexit, etc. It is as if they read the Wall Street Journal the morning of each FOMC meeting and quoted a few of the headlines to justify kicking the can down the road.

Simply put, there is no question that our economy has issues, but it is far better today than when the Fed was trying to avoid catastrophe back in 2008, and this inaction is destroying their credibility with investors.

IMPLICATIONS FOR INVESTORS

I am frequently asked why the Fed has resisted moving rates higher this year, but I do not know if I have a good answer. We live in a crazy world, and there will always be a weak spot in our economy or some geopolitical concern, so I cannot imagine that the Fed is waiting for some mythical utopian state before raising rates by a quarter of a point.

If I had to guess, I would say that they are just afraid. Keep in mind that the Fed employs some of the brightest economic minds on the planet, and Chairwoman Yellen even stated this week that the economy continues to improve. They see what we see.

However, the challenge for the Fed is that they have kept us in this low rate environment for so long that a lot of pent-up volatility has formed in select asset classes. If they move too fast, they risk destroying a lot of the progress, and I think they are scared to screw it all up.

This predicament leads us to then question what the future holds, and based on their commentary this week, it seems that we should expect one rate hike this year. December seems more likely than November, given we still need to get through what is arguably the most contentious presidential election in our nation's history.

Longer term, I see two trends that will remain in place as a result of the Fed's decision this week:

1. **The War Goes On:** They lowered their growth estimates through 2018, so expect to see rates remain artificially low for longer. Hence, the war on seniors and savers will continue as income on ultra-safe investments will remain less than stellar.
2. **Recession Risk Remains Low**: The Fed wants our economy to grow faster, and the risk of rampant inflation from keeping rates low for too long is nonexistent at the moment, so their inability to make tough decisions most likely will not cause any major harm.

The sad reality is that no matter how much I slam the Fed, they are the most powerful economic force in the world, and there is nothing that I nor anyone else can do to counter them. Investors who choose to fight the Fed are bringing knives to a gun fight.

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What we can do is prepare for the day when they do decide to raise rates by accepting the fact that although the ride will be bumpy, the absolute best outcome for the economy is a slow return to a normal interest rate environment.

The bottom line is that the Fed deserves the criticism they are receiving, but in the end, their decision to stay put does not pose any major risk to the economy at the moment.

Sincerely,

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