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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

The HFRI index of hedge funds has returned 3.24% over the past 5 years. The US stock and bond markets have returned 8.20% and 4.91%, respectively.

The White House said last month that the federal budget deficit for the current fiscal year will shrink to $759 billion. That's more than $200 billion less than the administration predicted just three months ago

Fed Policy and Interest Rates

The Federal Reserve occupies a prominent space in today's financial headlines. In May, its chairman Ben Bernanke hinted that the central bank's asset purchases might be coming to an end. This rattled the financial markets. Since then, the statements of the chairman and other central bank officials have been thoroughly parsed for clues as to near term policy changes.

Bernanke's term expires in January, creating additional uncertainty as new leadership may hold different priorities for the economy. This edition of Intelligent Money will review major Federal Reserve actions since the subprime crisis and speculate a bit on what it is likely to do in today's environment.

Recent Fed Policy Background

The policy area around which speculation swirls is the Federal Reserve's program of purchasing large amounts of financial assets. Until the subprime crisis, the balance sheet of the country's central bank was fairly stable and consisted primarily of treasury securities and short term loans. Since 2008, the Fed has been very active in the financial markets.

The Federal Reserve's policy of asset purchases, otherwise known as open market operations, is perhaps the most important policy tool in the central bank's arsenal. If it desires, the Fed can be the largest single buyer or seller of treasury securities, thus controlling the level of interest rates. The price of money is a key variable in stimulating economic activity.

The subprime crisis destabilized the financial system in late 2008. Banks stopped extending credit to their customers and to one another. Ordinary commerce was drastically curtailed and the risk of a depression was real. The Federal Reserve had a wide mandate to act to avert disaster.

The central bank went beyond the standard monetary tools used to drive down short term interest rates. The Fed embarked on an unprecedented foray of purchasing securities of varied credit rating and maturity. The idea was to provide money to banks so that they would lend while keeping the price of money (interest rates) low all across the bond yield curve. These asset buying programs have been described as "quantitative easing".

The first stage of quantitative easing (QE1) began in November 2008. The Fed bought up about $2.1 trillion in mortgage-backed securities and Treasury bills through June 2010. It marked the first time the Fed's open market operations included a substantial amount of assets other than treasuries. It was not only lowering interest rates but effectively maintaining a market for mortgage securities as buyer of last resort. There were very few other buyers out there at the time.

Despite the effort. the US economy stalled in the summer of 2010. Private sector job growth averaged 90,000 per month in the first half of the year while government employment stagnated. These figures were not enough to accommodate new job entrants much less reduce the unemployment rate.

The Federal Reserve embarked on a second round of quantitative easing in late 2010. The central bank started aggressively buying assets again – this time treasury bonds. Round 2 ran through June 2011 and the Fed added another $600 billion in treasuries to its balance sheet during this period.

Despite this monetary stimulus, the jobs market remained unsatisfactory. At midyear 2011, the economy had regained only 1.8 million of the 8.7 million jobs lost since the recession began. The labor market was simply not recovering as fast as it had after previous recessions. In late 2011,the Fed began buying longer dated treasury notes while selling shorter term treasury bills in a concerted drive to spur the economy. The program had the catchy name of "Operation Twist".

Operation Twist did not prove sufficient in stimulating economic activity. GDP growth dipped below 2%. 12.5 million were unemployed as July 2012 and 40% of these had not worked in 6 months or more. The Fed responded again with the announcement of QE3 in September 2012. The central bank targeted the purchase of $85 billion in long term treasuries and mortgages every month. Unlike past initiatives, the program was explicitly intended to reduce unemployment.

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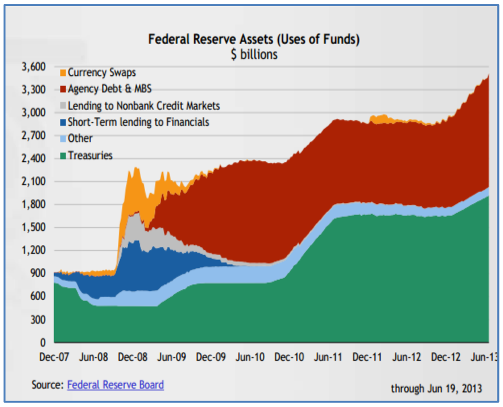
“Corporate earnings have not only recovered but have nearly reestablished the trend prior to 2008. American workers may still be reeling from the recession but not American shareholders.”

We will likely have to see material improvement in labor force participation, employment-to-population, and net job gains in order for the Fed to pare back purchases - Ben Bernanke, September 2012

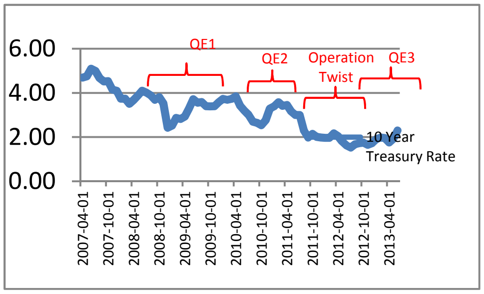
Moreover, Ben Bernanke pledged to keep short term rates low through 2015. This was strong medicine. The monetary program announced last September is still in effect. The question is now how much longer it will last.

The chart below describes the changes in the scale and composition in the Fed’s balance sheet in the aftermath of the financial crisis. Sometimes a picture is worth a thousand words and this one illustrates at a glance how times have changed at the Fed.



Mixed Signals from the Fed

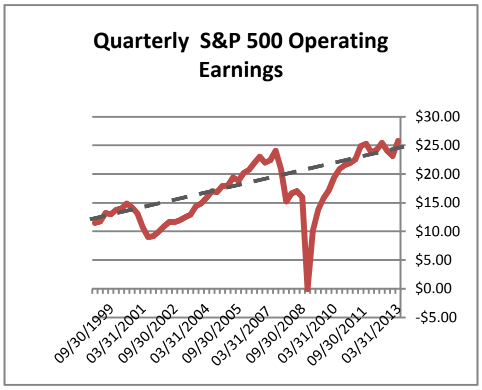
There is no question that the accommodative monetary policies of the Fed have driven down interest rates. Foreign investors have reinforced the effort by continuing to accumulate dollars. The world’s central banks are the 800 pound gorillas in the room and if they are buying bonds, prices are going up. The chart below illustrates.



Many financial analysts feel that the decline in interest rates has contributed to the buoyant stock market returns of the past few years. There is an obvious basis for this view. Stock valuations rely on discounting future earnings to the present. Lower interest rates mean that future earnings are worth more – they are “discounted” at lower rates.

It should be noted that corporate earnings have played a role as well in the recent bull market for stocks. Earnings cratered miserably during the recession. The decline in profits was more dramatic than what the economy experienced in the dotcom bust at the turn of the century.

However, an examination of the following graph reveals that the corporate earnings have not only recovered but have nearly reestablished the trend prior to 2008. American workers may still be reeling from the recession but not American shareholders.



Stock and bond investors are watching the Federal Reserve closely to infer future policy decisions. Three months ago, Ben Bernanke outlined the conditions under which the Fed would ease up on its QE3 program. If the economy improved as forecast, he anticipated that the program would begin to slow towards the 4th quarter and end in 2014.

The markets reacted swiftly to the chairman’s comments as US bonds across the spectrum sold off. The yield on the ten year treasury increased from 2.16% on Memorial Day to 2.73% by the July 4th weekend. Mortgage rates shot up as well

Fed officials were taken by surprise at the severity of the reaction. After all, Bernanke was merely outlining the conditions for the end of QE3, not announcing its end. Soon Fed officials were giving interviews and writing articles underscoring the ambiguity of the economic climate. Speaking before congress last month, the Fed chairman avoided any timetable for QE3.

I emphasize that, because our asset purchases depend on economic and financial developments, they are by no means on a preset course

"There are 12 voting members on the issue of monetary policy and it appears that at least half need to see further improvement in the economy and jobs before supporting a cutback in QE3."

"The feared side effect of inflation remains low despite the increase in the country's monetary base. In the 12 months ended in June, price levels increased only 1.8%."

Despite Bernanke's efforts to build consensus, There is some disagreement at the highest levels of the Fed. Minutes from its deliberations on policy in June were released just a few weeks ago. There are 12 voting members on the issue of monetary policy and it appears that at least half need to see further improvement in the economy and jobs before supporting a cutback in QE3.

Of course, our latest employment report was positive. If the next few months produce further job growth, then it is possible the Fed will reduce asset purchases.

Why end the asset purchases at all? Because the balance sheet expansion does come with risks. All the extra money in the economy could cause inflation. There is also a risk that foreign investors would lose confidence in the dollar and shift investments to other currencies. The Fed might lose control over interest rates.

Some economists feel that all this bond buying has little effect on economic growth. Banks are retaining excess reserves anyway. Adding more to the system need not have a meaningful economic effect.

The Current Economic and Political Climate

It is likely that this will be Ben Bernanke's last term as Fed Chairman. In June, Barack Obama told interviewer Charlie Rose that Bernanke has "already stayed a lot longer than he wanted or he was supposed to." Sounds like Bernanke's second term will be his last.

Two probable successors have emerged in Janet Yellen and Larry Summers. They are both very experienced economists with public sector experience. She is currently the Fed's vice-chairman and has been vocal in terms of support for full employment as a Fed policy objective. This suggests that she will be at least as likely as Ben Bernanke to maintain asset purchase programs in place. In April 2013,she opined:

> With unemployment so far from its longer-run normal level, I believe progress on reducing unemployment should take center stage for the [Federal Open Market Committee], even if maintaining that progress might result in inflation slightly and temporarily exceeding 2 percent.

Larry Summers served as Bill Clinton's treasury secretary and headed up Barack Obama's National Economic Council. There is some evidence that he would be quicker to reduce the Fed's asset purchase programs. At an investment conference in April, he said:

> QE in my view is less efficacious for the real economy than most people suppose

It's tough to infer policy views from off-the-cuff remarks. Both Yellen and Summers have distinguished academic credentials and will adapt policy to economic reality. However, all else being equal, QE3 probably ends sooner under Larry Summers.

The macroeconomic environment will at least tolerate, if not require, continued additional asset purchases from the Fed. The feared side effect of inflation remains low despite the increase in the country's monetary base. In the 12 months ended in June, price levels increased only 1.8%. Inflation has been low during the entire period since quantitative easing went into effect.

There is little indication of a flight from the dollar. Other central banks are engaged in highly accommodative activities as well. The Bank of Japan announced a massive monetary stimulus in May that is roughly 3 times the size of QE3 when adjusted for the size of the Japanese economy.

The European Central Bank (ECB) deliberately distanced itself from the Ben Bernanke's intimations of an end to QE3. Senior banking officials there have stated that there no end in sight to their own accommodative monetary policy. The Eurozone unemployment rate is over 12% and southern European bond markets are being propped up by an explicit guarantee by the ECB. Bottom line is that there is little likelihood that bond investors will flee the dollar in the short run for the "greener" pastures of Europe or Japan.

Another key reason why the Fed will be reluctant to let interest rates increase is that the US Treasury is the world's largest borrower with a debt of $16.4 trillion. The suppression of interest rates has reduced our annual debt service to *only* $370 billion. That's comparable to fiscal year 2000 when the national debt was only a fraction of today's figure.

If the cost of borrowing were to increase to 4%, the government's debt service would balloon by $350 billion. To put things into perspective, that's about half the defense budget and half the projected deficit for fiscal year 2013. That's real money.

Would a "lame duck" Fed chairman end quantitative easing while inflation is low, unemployment remains high, and other central banks are printing money? That's a tough case to make, especially when the financial markets sell off at the first whiff of tightening.