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SO, WHAT SHOULD THE FED DO NEXT?

The Employment Act of 1946 mandated the US government actively promote full employment, steady growth and stable prices through the use of fiscal and monetary policy.

December 2013

In This Issue...

We could spend hours discussing both fiscal and monetary policy, but for now let's focus on just monetary policy; policy executed by the Federal Reserve.

I am convinced actions taken by the Federal Reserve and others during those dark days of 2008 and 2009 prevented the collapse of the US financial system. By flooding the system with money, the Fed was able to increase the reserves US depository institutions held and thereby assure both Americans and the greater global community that the US financial community was safe and open for business. By lowering target federal funds rates to historic lows and buying fixed rate bonds and mortgage backed securities in the secondary bond market, the Federal Reserve has been able to flood the system with money and thereby keep short-term rates at near zero and longer term rates almost as low. Their efforts have had significant positive impacts on both bank and non-bank institutions. According to the Federal Reserve, as of November 14, 2013, US depository institutions held $2.3 trillion dollars in excess reserves compare with $ 797 billion in January 1, 2009.[1] Non-bank institutions have also benefitted handsomely. At the end of the first quarter ,US non-financial institutions held an additional $1.73 trillion dollars in cash, partly due to their ability to borrow at those previously mentioned near-zero rates.[2] I like all this and as I said earlier, I believe history will give the Fed two thumbs up for actions taken, at least thru 2012; but how about the rest of the economy? How have we fared?

Consumers with jobs and good credit have been able to borrow for big ticket items like cars and houses at incredibly low rates; that's a positive. Employment is still stubbornly high; some would say that's a negative, but as I said in the November 2012 newsletter, neither central banks nor governments create jobs, so the Fed gets a bye from me on that one. And savers; how have they fared? Well, here's where I think the Fed could have done more and, at the same time perhaps had at least an indirect impact of unemployment. Here's why... and I'm posing this is a question, not a criticism.

According to the FDIC, as of June 30, 2013, US banks held approximately $1.7 trillion dollars in time deposits and another $4.4 trillion in money markets; that's over $6 trillion dollars in total.[3] As savers are painfully aware, those monies have been earning almost nothing. What would have happened if the Fed in late 2012 had begun to let interest rates rise a little? Would some of those savers holding that $6 trillion dollars spent some of their increased interest? I'm thinking the answer is yes. And if they had spent it, wouldn't the economy gotten a tad stronger? And if the economy had strengthened due to increased sales, what might have happened to

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"While money can't buy happiness, it certainly lets you choose your own form of misery." — Groucho Marx

So, what should the Fed do next? continued

unemployment? Well, as my old friend John Maynard Keynes would say .. since employment depends upon planned spending, I suspect unemployment might have gone down a little more than it has so far. I acknowledge the downsize might have been pressure on the housing market, but my gut feeling is potential home buyers, knowing mortgage rates were headed permanently higher, wouldn't sit on the sidelines too long. How high would rates have to go for my scenario to work out? I don't know, but I suspect not very high. What do you think?

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1. Data Source: FRED, Federal Reserve Economic Data, Federal Reserve Bank of St. Louis: Excess Reserves of Depository Institutions; accessed November 15, 2013
2. Corporate America's Mountain of Cash is Getting Bigger, Sam Ro, Business Insider.com May 23, 2013
3. FDIC-Statistics on Depositor Institutions Report as of June 30, 2013. Accessed November 15, 2013

Stock Markets

Here are three quotes worth reading; one from ten years ago and two more recent:

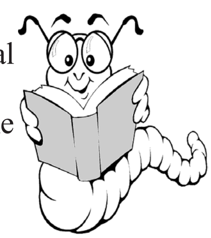
1. In 2003, Robert Sheller wrote the following in his book *Irrational Exuberance*: "The high recent valuations in the stock market have come about for no good reasons. The market level does not, as so many imagine, represent the consensus judgment of experts who have carefully weighed the long-term evidence. The market is high because of the combined effect of indifferent thinking by millions of people, very few of whom feel the need to perform careful research on the long-term investment value of the aggregate stock market, and who are motivated substantially by their own emotions, random attentions, and perceptions of conventional wisdom." Sounds like something to think about in late 2013.

2. From the front page of Value Line Selection and Opinion, November 8, 2013: "the steady climb in equity prices has put valuations at highs not seen in years, and lowered dividend yields to levels rarely plumbed. That one-two punch is raising the risk of holding stocks".

3. And from the subsequent edition of Value Line, November 15, 2013: "…and investors tolerance for risk remains high. This observation suggests the stock market is overheated at present."

Am I suggesting you sell everything and put your money under the mattress? Of course not; I'm just reminding you nothing, including stock markets, go up forever. Sometimes they go flat and sometimes they go down ...but they never keep going up forever.

The Book Worm



Confessions of an Economic Hit Man by John Perkins. A the author's personal account of corporate America's role in foreign policy. Like a lot of exposes, the author's writing skills are suspect but the story is fascinating.

Atomic Ranch: Design Ideas for Stylish Ranch Homes by Michelle Gringeri-Brown. More pictures than words, the book is a celebration of the much maligned ranch style architecture popular in the middle of the 20th century.

Who Stole the American Dream? by Hedrick Smith. A very sober look at today's income disparity by a seasoned and very respected reporter.

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Bond Markets

Unless you were a bond investor in the late 1970s, you are probably unaware of a couple rules all bond investors should know. Rule #1: when interest rates go up, the market value of bonds go down. Rule #2: the longer the maturity, the more dramatic that decline is going to be. Given the historically low rates we see today, I am pretty sure someday those rules are going to have an impact on bond investors' portfolios; it's just a matter of time. So, let's go to the classroom and see if I can explain them to you.

For our exercise, let's pretend you invested $10,000 in the following bond last year when it was originally issued: $10,000 ABC Corporation Bond 3% due December 31, 2023 dated December 31, 2012. From the description we can learn several things.

* Issuer (borrower) ABC Corporation sold this bond to the public in December 2012 in the primary market
* Coupon of 3% indicates ABC Corp promised to pay the investor $300 each year over the life of the bond
* Maturity date is December 31, 2023, that's when ABC will repay the loan (in your case $10,000)

Okay, it's a year later (2013) and we are going to assume interest rates have risen; ABC Corp will now have pay investors 4% on any newly issued bond . This means a newly issued $10,000 bond maturing in 2023 (10 years from now) will provide an investor $4,000 in cash benefits over the next 10 years (10 years times $400). The old bond you purchased last year will only provide you with $3,000 in cash benefits over same period (10 years times $300). If you need to sell your bond today in the secondary, investors are going to demand the same $4,000 cash benefits from your bond as they are demanding from a new one. So, to even things out, those investors will only pay you $9,000 for your old bond because, at that price, they will receive $3000 in interest and an additional $1,000 at maturity ($10,000 maturity value minus the original cost of $9,000). In the secondary bond market no one will pay you more than your bond is worth relative to current market conditions. That's Rule #1. Okay, that's half the lesson. Now, for Rule #2. Go back to our example and answer this question … if the maturity had been 2033 (20 years), how much would your old bond be worth? And 2043 (30 years)? Call me if you need help with the math ☺

For full disclosure, I both grossly over-simplified the mathematical calculations and exaggerated the outcome to get your attention. But the risks are real and when interest rates rise, the market value of bonds will decline. Here's a real example: Investors purchasing twenty year maturity US government bonds in 1977 assumed they were investing in the safest investment in the world. By June 1980, those safe investments had declined almost 25% in market value.[4] So, am I suggesting no one should own bonds? Of course not. I am saying, however, if you own bonds, we should talk.

4. Wall Street Journal; January 3, 1977 and June 30, 1980

Housekeeping

Couple of things: (1) As most of you know, from time to time, security industry regulations require us to verify the information we have on file is both accurate and up to date. This time around regulators have added a few more questions for us to ask .. so bear with us as we go thru the process. (2). Technology has brought a lot of changes to our lives over the last twenty or so years; one of the most significant has been the use of electronic statements in lieu of traditional paper alternatives. I suspect, at least for the next few years, paper statements will continue to be available. But a day is coming when electronic statements will be the only option… so why don't we take a look at that option now and at least familiarize you with that process. Call me and let's talk.

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