All Eyes On The Fed

What a year for stocks! The equity markets were up 32 percent in 2013. Since it's only appropriate to give thanks at the end of the year, let me be the first to say, "Thanks, Chairman Bernanke." And, like any spoiled child would do, let me ask incoming Chairwoman Yellen, "What are you going to give us in 2014?"

If you have ever doubted the importance of the Federal Reserve or the adage "Don't fight the Fed," just look at the performance of the markets since March 2009. As you can see from the chart on page 3, in less than five years the Fed has added massive liquidity to our financial system (by purchasing more than $2 trillion in bonds), while the stock market has increased by more than 200 percent.

Dictating monetary policy is not easy. The Fed's decisions sometimes result in redistributions where there are both winners and losers (e.g., borrowers love low rates; savers hate them). But possibly the most difficult part of any decision made by the Fed is the length of time it takes to see the impact.

The Fed's primary lever is to raise or lower the Fed funds rate. It lowers the rate to stimulate the economy (to boost growth), and it raises the rate to slow the economy (to fight inflation). Of course, when the Fed changes the funds rate, the economy does not immediately change. It takes time. This reminds me of taking a hotel shower. The water is too cold so you turn the knob to a hotter level. Still too cold. Turn it hotter. Not warm enough yet. Turn it up some more. Suddenly, the water is absolutely scorching. Turn the knob sharply back to cold. The temperature is great for just a moment, and then it turns ice cold!

So like navigating the hotel shower, the Fed has to anticipate when it needs to turn its levers to make the temperature perfect for our economy – not too hot or too cold. To do this, the Fed has to forecast six to 12 months out. In fact, that's what the Fed is doing right now.

Reflecting upon the 2007-09 financial crisis, you may recall that home prices were down more than 30 percent nationally and over 50 percent in several states. Equity prices also were down more than 50 percent. Lehman failed, other large investment banks were in trouble and the government had to bail out AIG, Fannie Mae, and Freddie Mac.

The Fed responded to this chaos by instituting a series of interest rate cuts over a 15-month time period that dropped the Fed funds rate from 5.25 percent in September 2007 to a target of 0 to .25 percent. Of course, at that point, rates could not go any lower so the Fed turned to non-traditional tools. It engaged in quantitative easing where the Fed bought Treasury bonds and mortgage-backed securities. The idea was to push rates lower through these purchases and to add liquidity in the form of bank reserves. In addition, the Fed wanted to push investors into riskier assets such as stocks. As stock prices increased, we all started feeling better. This was "the wealth effect" in action. The Fed also pledged to keep rates low and monetary policy accommodative for the foreseeable future.

In recent months, all of the talk has been about tapering (i.e., lowering the amount of bonds the Fed purchases each month). On December 17, the Fed announced that it will reduce its monthly purchases from $85 billion to a "paltry" $75 billion. Just in case this small tweak to the bond buying bonanza upsets the market, the Fed also announced that there is no set schedule to completely stop buying bonds and that its monetary policy will continue to be accommodative (i.e., keeping the Fed funds rate low), even after the bond buying is done. The stock market rallied even further after this announcement.

The question on the minds of many investors is when will the quantitative easing program stop and when will the monetary policy become less accommodative (i.e., the Fed starts raising rates). None of us can predict the answer, but our guess is that there are several reasons why the Fed will remain very accommodative during 2014:

- **The unemployment rate is still high.** While the unemployment rate has fallen from 10 percent in 2007 to the current rate of 7 percent, much of this decline is the result of people dropping out of the labor force. If the participation rate had not decreased so much, the unemployment rate would still be above 9 percent.

- **Fiscal policy is not accommodative.** Normally when economic growth slows, fiscal policy expands. But, as we continue to run large deficits and our debt levels increase, it is very unlikely Congress is going to cut taxes or increase spending in a significant way. To some extent, the Fed is trying to counteract the impact of fiscal policies, including Congress' current standstill.

- **The Fed is fearful of spooking the equity markets and the housing market.** Much of the economic confidence that has returned can be traced back to rising stock prices and a bounce in home prices. The Fed fears a restrictive monetary policy could put an end to these rallies.

- **Inflation is far below expectations.** Of the reasons I've listed, inflation is the most important issue to watch. Many commentators believe the Fed's accommodative policy will cause inflation. You see, when the Fed buys these bonds, it is simply creating money! That's right; the Fed credits the accounts of the financial institutions that sell these bonds. The worry is that this accommodative policy will cause inflation *if* these reserves are loaned out.

The reality is that these reserves are *not* being loaned out. However, the other reality is that the Fed's favorite measure of inflation (the PCE Price Deflator) is showing inflation just above 1 percent and trending down. The Fed's greatest fear is living through Japan's recent 20 year nightmare of deflation. One of the lessons the Fed learned from Japan is that its accommodative policy should not stop too soon. It would be a terrible sign if the Fed slowed its accommodative policy and was then forced to restart it. Our conclusion from this analysis is that the Fed will continue to remain accommodative.

Next, we must ask if the stock market is currently overvalued, given the significant rally over the last five years. The market is not cheap, but we would not judge it to be extremely overvalued. The market is currently trading at 17 times earnings compared to a historical average of 16 times earnings. If the market moves much closer to 20 times earnings, we might examine valuation further.

It is evident that there is still plenty to worry about. We are overdue for a stock market correction (a 10 percent drop in the market). On average, the stock market has experienced a correction every 10 months. However, we have not experienced a correction in over 20 months. We all know markets do not go straight up. As a result, a correction would not surprise us. But, barring any new information, such as an increase in inflation or a significant drop in profit margins, we would view a correction as an opportunity for investors to increase their equity allocation if they are below their target allocation range.

With respect to the bond market, interest rates have risen dramatically this year with the yield on the 10 year Treasury increasing from 1.6 percent in May to 3.0 percent currently. We think it is likely interest rates will continue their upward trend over the next several years. However, given our views on inflation and the Fed, there's nothing to say that this will happen soon. We feel investors should avoid the temptation to stretch for yield by investing in longer-term bonds. Ultimately, the increase in interest rates should be viewed as a positive for bond investors since this will create an environment where you can once again earn a real positive return on your bond investments.

In sum, we expect the Fed to continue to be accommodative. We're not going to fight the Fed or the market, nor will we try to time the market. We'll continue to monitor changes in inflation, profit margins and money flows. At Trust Company, we will work hard to help you, our clients, be in the best position for whatever the market and the Fed have in store for us.

James F. Arens II
Executive Vice President