Infomail
September 30, 2015

Fed Frankenstein

"A man who does not read the newspaper is ill-informed, but one who reads the newspaper is misinformed"
Mark Twain, American Author & Humourist 1835-1910

It seems that the world is constantly in a state of flux and change, but despite the fact that the speed of that transformation seems to be getting faster with technology, one thing that doesn't seem to change much is human nature. That's because humans are a complicated mammal mainly driven by emotions. Anger, love, grief, pleasure, pain, happiness, sadness, are but a few which drive us. In our business, the two most powerful are fear and greed.

Since human nature does not change very much, we can use history to learn from the past, apply it today, use reason to create an opinion, and use it to make decisions for the future. Trying to predict the future is a big part of investing.

Which brings me to the US Federal Reserve.

Fed policymakers have put themselves into a bit of a box. In reaction to a financial crisis in 2008-09 the Federal Reserve took out every tool it had available. In fact, it created new ones. It tried things that have never been tried before, taking one stimulus and combining it with another and seeing what would happen. They created a Fed Frankenstein if you will.

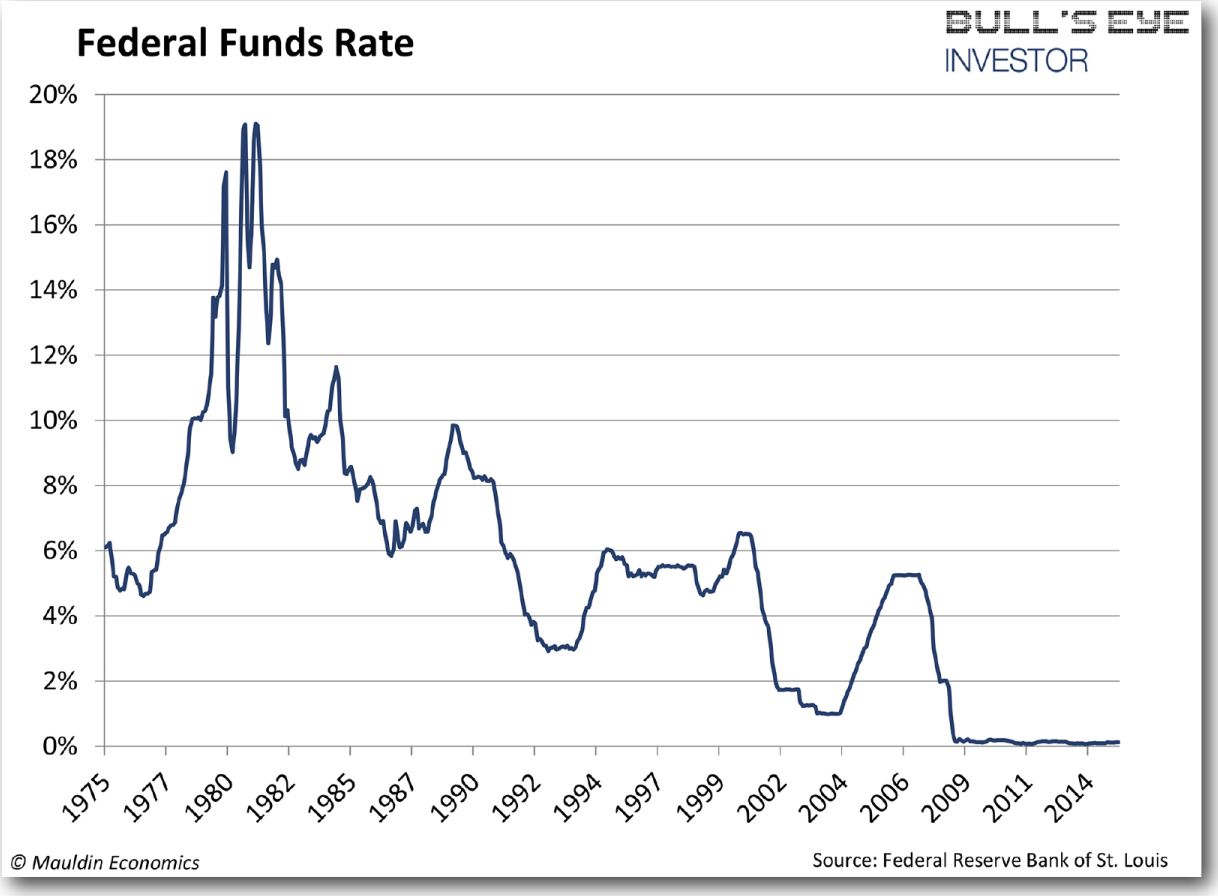
So a whole bunch of new Fed programs, many with cool sounding acronyms came into being:

- Quantitative Easing 1 & 2 (QE)
- Term Auction Facility (TAF)
- Primary Dealer Credit Facility (PDCF)
- Term Securities Lending Facility (TSLF)

- Troubled Asset Relief Program (TARP)
- Term Asset Backed Securities Loan Facility (TALF)

Among many others……

……and of course cut interest rates from 4.25% in January 2008 to near zero.



Central bankers are conservative people. They take great care in implementing policy. They speak precisely. They over-explain. And they study the economic environment trying to pinpoint where the next disaster looms.

Good monetary policy is usually marked by its predictability, but when the world changes, policymakers should change with it. But they are human in the end, and here's where that human nature part kicks in: They don't want to be embarrassed.

Fed Chair Yellen doesn't want to be the one who raises rates too early and possibly send the US back into recession, or even worse, create another global crisis from the impact of US policy.

In reality, who knows? I really don't think Ms. Yellen really knows, because there are two types of errors the Fed can make:

1. They raise too early, plunging the US economy back into recession
2. They raise too late (if at all), causing inflation

I believe all central banks all over the world right now are actually trying to get as much inflation as possible going, because deflation is the elephant in the room no one wants to discuss.

In addition, 2016 is a Presidential election year, and generally in election years, the Fed usually sits on its hands so as not to be perceived as favouring one side of the other. If the Fed raised too early and created a recession heading into an election, it would create havoc. It also doesn't help that all current voting members of the Fed were appointed by the Democrats.

And then there is recent history for them to learn from. Japan hiked rates 15 years ago pushing deflation even higher, a huge policy mistake. And in 2008, just before the "crash," ECB head Trichet raised rates which may be considered one of the dumbest central bank moves……ever.

Janet Yellen is not going to make that mistake.

So the debate rages daily as to the timing and the eventual "size" of the Fed's tightening cycle which many think is now "too little, too late." The Fed could have raised a notch as early as 2012, or even earlier this year. Based on prior Fed rules-based methodology, the current policy should be at 2%-3% instead of zero. But the box the Fed has put itself in, doesn't allow them any flexibility without spooking markets or creating self-inflicted financial instability.

Fed policy, combined with massive government spending deficits, fiscal austerity programs and massive currency devaluations taking place globally create a new kind of Frankenstein, the results of which remain to be seen.

Fed policy does matter. It can be argued that then Fed Chair Greenspan's insistence on keeping interest rates at 1% well into 2004, when the economy was humming along nicely, was the <u>number one</u> contributing factor to the subsequent housing bubble which burst in 2008.

The current Fed Board of Governors is comprised of three economists and two lawyers, led by Janet Yellen who hails from Brooklyn. Even though Brooklynites tend to be aggressive, Yellen is not a risk taker. I would even call her risk averse.

So she will do what human nature predicts. She will not raise too soon (or too much) and risk being embarrassed. If there is no increase in 2015, it could be 2017 until we see one.

Stay tuned,

Vito Finucci
Vice President and Director
Investment Advisor