Investment Watch

3rd Quarter, 2014

Just Right?

Could that be our Federal Reserve Chairwoman Janet Yellen dressed in her Goldilocks costume? She's hoping for the porridge that's just right, that *"not too hot, not too cold"* Goldilocks economy. The Fed will most likely have ended their last round of Quantitative Easing, **QE3,** just before Halloween this year. The Fed weaved their magic with this massive, unprecedented stimulus two years ago. **QE3** was concocted to jump start our economy after the Fed had exhausted conventional means by lowering the **Fed Funds Rate** effectively to zero.

The near-zero Fed rates did depress short-term interest rates. But our economy was still *too cold*, unemployment remained stubbornly high, and banks were afraid to lend. So the Fed's storyline continued with an untested variation on quantitative easing. This expansionary monetary policy usually involves purchasing short-term bonds with newly printed money. But with short-term rates already near zero, normal methods don't work. Rather than purchase short-term bonds, they experimented with purchasing longer-term bonds intending to lower longer-term rates. A double dose of easy money—(1) The Fed's near-zero interest rate policy held down short term rates while (2) **QE3** lowered longer term rates to rock bottom levels.

Many pundits called these unconventional monetary experiments a witch's brew which would surely ignite inflation and derail our fragile economy. But *unusually uncertain times* required inventive solutions. **QE3** grew to a monthly $85 billion behemoth, bloating the Federal Reserve balance sheet to $4.5 trillion. However, the experiment may have worked -

- Longer-term interest rates hit historic lows,
- Low mortgage rates made housing more affordable,
- Banks profited and shored up their balance sheets,
- The $1 trillion annual budget deficit was halved in 2014,
- Debt service on our national debt as a percent of GDP is now lower than it was 40 years ago,
- Unemployment has been steadily declining,
- Asset prices inflated boosting personal wealth, and
- Consumer spending and confidence have been rising.

Central banks around the world have followed suit with our Federal Reserve's lead of quantitative easing trying to jump start their economies.

Unwinding **QE3** began last September shaving $10 billion each Fed meeting. With the current bond purchases standing at $15 billion, the Fed is expected to end them altogether at their next meeting on October 29th. In May of 2013 when the unwinding of **QE3** was announced, interest rates soared. The 10-year Treasury Note's yield skyrocketed from 1.5% to just over 3.0%. Many feared that this was the start of an interest rate and inflation spiral. Contrary to expectations, interest rates have actually fallen since then with the 10 year T-Note now at 2.5%. **QE3** appears to have accomplished its goals. The pros and cons will be debated for years, but this Halloween we all have to **say goodbye to QE3.**

Just like too much candy on Halloween can cause a stomach ache, many believe that the Fed's easy money policies have fueled future inflation and caused a financial bubble. Surprisingly, current inflation rates have been as cold as Mama Bear's porridge with the August core CPI going nowhere, the first unchanged reading since October 2010. Over the last year the core-CPI is only up 1.7%. Globalization and the still relatively high unemployment may be holding consumer prices down.

Goldilocks can't fall asleep in Baby Bear's bed quite yet. The Fed's next step is to raise the **Fed Funds Rate** from it's near-zero level without cooling the economy and without scaring the stock market. This won't be easy. However, our low inflation affords the Fed more time and they are expected to delay raising rates until next October.

Stock analysts mostly agree that the easy money has inflated stock prices beyond their historical averages. Low interest rates support higher stock prices. The stock market bulls are relying on the economy to grow into the higher prices, while the bears are expecting a correction. The stock market has been resilient in light of all the global disruptions while interest rates have receded during **QE3's** unwinding. There is underlying strength in our economy, but will it be enough to withstand increasing interest rates?

As vice-chair of the Federal Reserve, Yellen was a strong advocate of these easy money policies. Now as Chairwoman she must be a leader and seek a consensus of the Federal Open Market Committee who will set the future Fed Funds rate. It may be a bumpy road. The bears may come home early, but we, like Yellen, can't run into the forest and hide.

September 30, 2014

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