Investment Watch

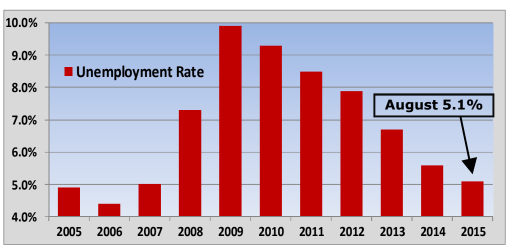
3rd Quarter, 2015

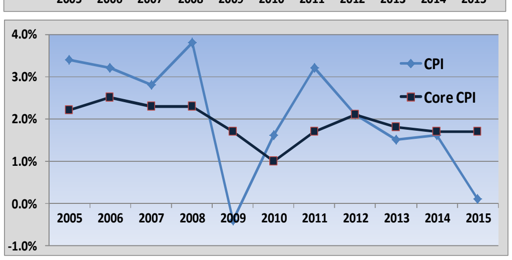
Fed Does Nothing?

It's just a couple months shy of seven years since our Federal Reserve undertook their unprecedented **zero interest-rate policy (ZIRP)**. Under ZIRP, conventional monetary policy is maximized at a zero bound limit to drive growth, but sluggish growth has persisted. Many economists had predicted that the Fed would begin raising rates at their just-ended September meeting because the unemployment rate had dropped to 5.1%. But Fed Chairperson, Janet Yellen, along with all but one member of the Federal Open Market Committee (FOMC) sat on their hands and voted to do nothing, keeping rates at zero.

Congress enacted the Federal Reserve Act which, as amended in 1935, created the Federal Open Market Committee. FOMC is a twelve member committee consisting of the seven Federal Reserve Board Governors and five Reserve Bank Presidents. The FOMC is responsible for the open market operations, that is, the purchase and sale of securities on the open market and establishing the federal funds rate. The fed funds rate is the rate at which banks and credit unions trade balances held at the Federal Reserve and has effectively been at zero for almost seven years!

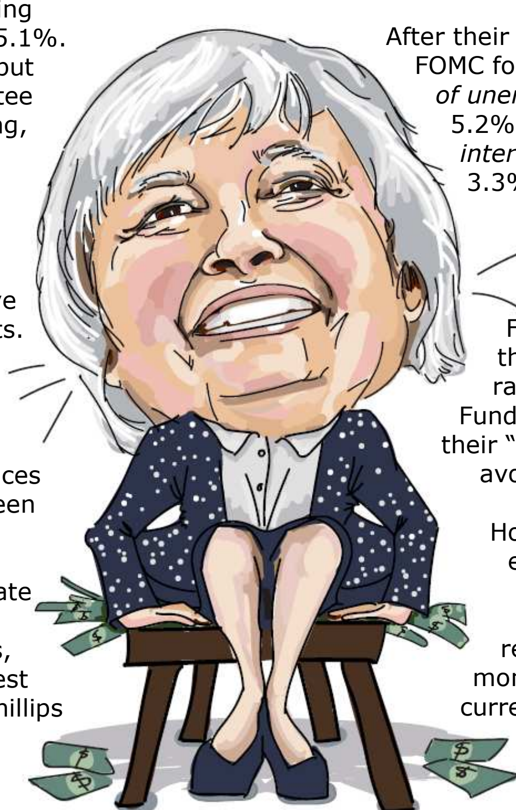
The Federal Reserve Act imposes a statutory dictate on the FOMC known as the *"**dual mandate**",* to promote maximum employment and stable prices, along with maintaining moderate long-term interest rates. In 1958, New Zealand economist A.W.H. Phillips noted and charted that there exists an inverse relationship between inflation and unemployment which is known as the Phillips curve. Therefore this *"**dual mandate**"* imposes a problematic balancing act for the FOMC. Relying on the Phillips curve, many pundits believe ZIRP will promote job creation, but will also spark an inflationary spiral. Most monetary policy debates center around the validity of the Phillips curve.





Source: US Bureau of Labor Statistics

In 1967, Milton Friedman presented his theories *"The role of monetary policy"* to the American Economic Association, which laid the academic groundwork that has influenced US monetary policy for nearly 50 years. He conjectured that there is a *"natural rate of unemployment"* which is the point when there is equilibrium at which wage increases are dictated solely by inflation and not by supply and demand. He theorized that if unemployment fell below this *"natural rate"*, inflation would spiral out of control. Friedman hypothesized that easy money policies like ZIRP would destroy this natural balance by fueling future inflation resulting in long-term economic anxiety.



After their September meeting, the FOMC forecasted the *"natural rate of unemployment"* at 4.9% - 5.2% and the *"natural rate of interest"* (Fed Funds Rate) at 3.3% to 3.8%. With the August unemployment rate declining to 5.1% within the FOMC's *"natural rate"*, Friedman's monetarist theory would mandate rapid increases in the Fed Funds Rate to move toward their *"natural rate"* in order to avoid igniting future inflation.

However, in light of the economic softness abroad and ongoing deflationary forces, Yellen's Fed has reasoned that Friedman's monetary theories will not currently hold up and believe that unemployment below the *"natural rate"* will not trigger higher inflation. In fact, their minutes explain that even with unemployment and inflation near their *"natural rate"* that the current, *"economic conditions may, for some time, warrant the target federal funds rate below the levels the Committee views as normal in the longer run."* Yellen intends to start to raising rates before yearend, but the phrase ***"Low for Longer"*** expresses both her and the FOMC committee's prolonged strategy.

The Fed's monetary policies have been shaped by Milton Friedman's theories for decades. But now in our low inflationary environment with *"global economic and financial developments...likely to put further downward pressure on inflation",* the Fed reasoned that they have time to sit on their hands. By doing nothing, the FOMC is promoting growth to meet their "**dual mandate"** to *"foster maximum employment and price stability."*

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