Magellan Planning Group, Inc.

The *Real* Problem with Rising Interest Rates

-J. Kevin Meaders, J.D., CFP®, ChFC, CLU*

January, 2016—What kind of economy do we live in where all economists and TV pundits do is sit around and wait to see (and talk about) what our central bank is going to do with interest rates?

All discussion is centered on what the Fed will do with rates. There's even a Fed Announcement Countdown Clock. There's no discussion about our massive debt, or taxes, or earnings, or profitability, or dividend growth, or debt service.

No. Everyone is completely transfixed on what a group of old academicians around a big fancy table will do. (If you've ever read Ayn Rand's *Atlas Shrugged*, then you know exactly where I'm coming from. If you haven't read it, I urge you to do so.)

Surely I'm not the only one who thinks it exposes a fundamental flaw in our Keynesian economy that we could even be at near zero interest rates. Simply unbelievable. This would never happen in a free market economy where prices are set by a meeting of the minds between a willing buyer and a willing seller at arm's length.

And, yes, interest rates are prices. They are the rental price of money. So an artificially declared interest rate is like price controls on our money. Haven't we seen by now that price controls are not a good idea?

Price controls inevitably create a secondary (sometimes black) market, and we've seen this with bit-coin and gold and silver bullion sales: 2015 saw the highest level of Silver Eagles sales ever![1]

So the price of our money—interest—just went up by ¼ of 1%. Everyone was more or less expecting it, and so far the market hasn't crashed. *Maybe it never will?* But I think you are too smart to believe *that*.

Now the buzzword is "gradual" increase rather than "structured" increase. In *Fedspeak* this means that instead of raising rates as a matter of course every time the Fed meets, they may raise them and they may not as conditions dictate, or rather, how their interpretation of conditions appear.

The value of our money has been artificially controlled and devalued for over a century, since

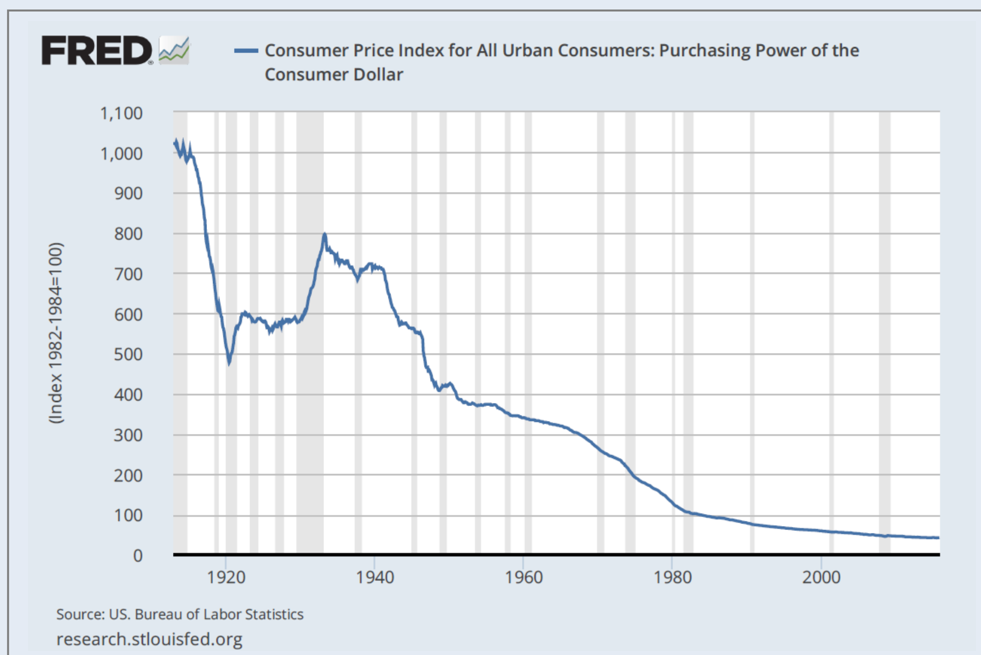
[1] *Silver Coins Today, American Eagle 2015 Silver Bullion Sales End at All-Time Record. Dec 18, 2015*

the Federal Reserve Act of 1913. In addition to manipulating interest rates, the Fed has another tool—printing (electronically creating) money as a way to increase the money supply, and thus increase inflation.

You may remember that Nixon took us off the gold standard in 1971, after which massive inflation engulfed our economy. But this wasn't really a gold standard, in that each dollar represented a given weight of gold, but rather an ounce of gold was pegged to a certain price: $35. Another price control, doomed from inception.

The whole point of having a gold standard is to restrict the unfettered printing of dollars, which is exactly what the Fed did, thus causing each ounce of gold to "represent" more than $35. When we came off the gold standard, the price of gold immediately shot up to $70. By 1974 it hit $195.[2]

It wasn't that gold had become more valuable, but that the value of the dollar had decreased because there were so many more dollars. The chart below shows the destruction of our dollar by those pretending to protect it.

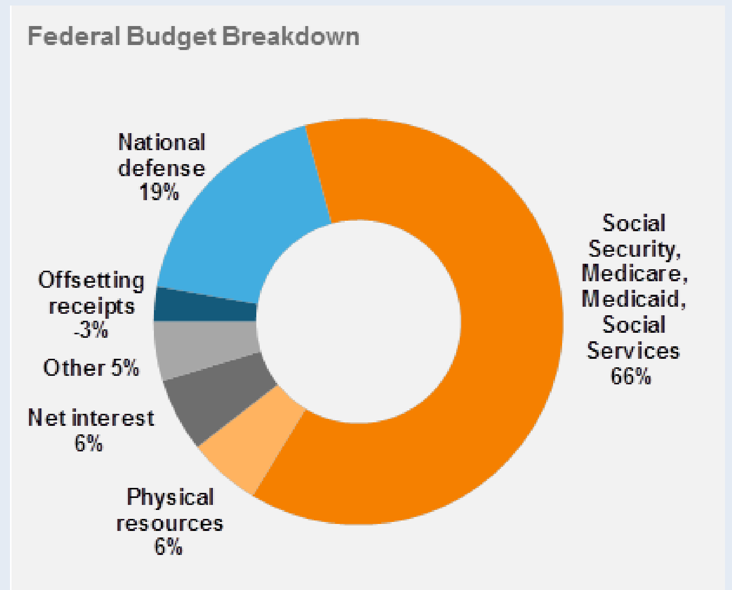


Essentially the chart illustrates that every dollar in 1915 would be worth less than five cents today. There is no other cause for this than the dilution of your earned and saved dollars by effortlessly created, and spent, dollars. This is worse than taxation; it is pure theft. But it is silent, imperceptible, bewildering, and often completely beyond suspicion.

Warfare and welfare are always the excuses given to perpetuate the scheme, and since most of the nation is either getting a check (directly or indirectly) from the government or the military-industrial complex, no one wants to listen to nay-sayers like me who ask: "How long can this go on?"

2 Fed Fred. Gold Fixing Price 10:30 A.M. (London time) in London Bullion Market, based in U.S. Dollars

The chart to the right shows the federal budget breakdown. A whole two-thirds—66%—of the budget is gone right off the top just due to Social Security, Medicare, Medicaid, and Social Services.

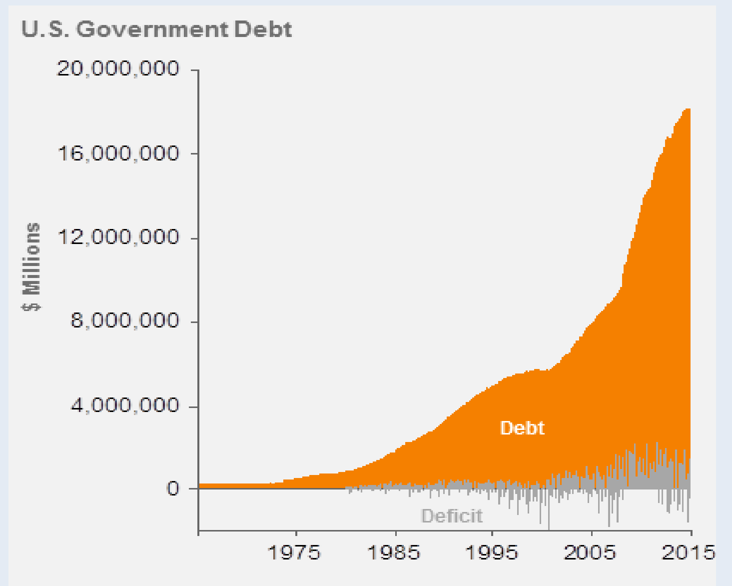


Source: Congressional Budget Office, Office of Management and Budget

Add another 19% for National Defense, and we have already spent 85% of our budget before we even open the doors on January 1st.

Expenses aren't a problem as long as you have sufficient revenue (cash flow) to fund them; but we don't. Of a roughly $4 Trillion budget, we can pay for about half of it. The rest we have to borrow. Thus our next largest expense is interest on our debt. And that debt is expanding at an increasing rate; an alarming rate.

Again, nothing tells the story like a chart, and here it is. Note that the numbers are denominated in millions of dollars. Thus, our current debt is approaching $20 Trillion, and will very likely surpass that in 2016.

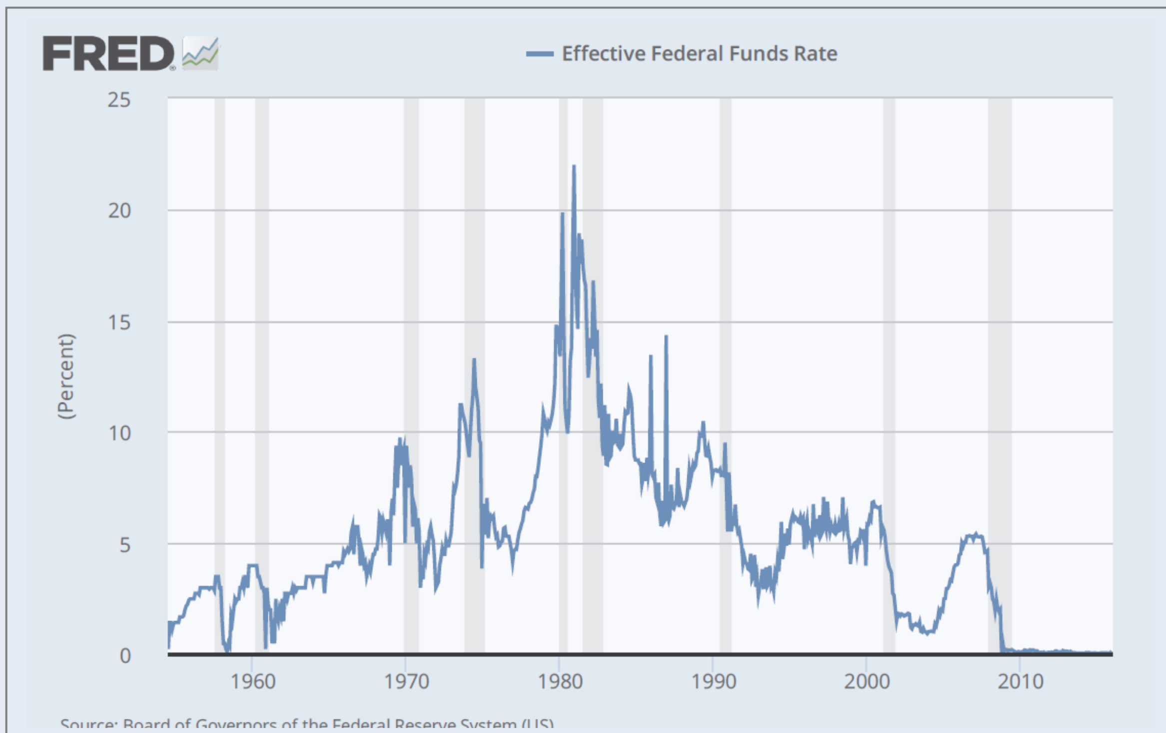


Source: Congressional Budget Office, Office of Management and Budget

What do you think the rate of interest is on all this debt? The answer: it *has* been very low. And what has just happened to interest rates? As more and more debt is piled on, and the interest rate on that increasing debt is itself increasing, the net result will be more interest, thus a larger interest payment, thus a larger budget deficit, thus more debt, *ad infinitum* until….What?!?

As utterly unpleasant it is to face these facts, I again must ask, "How long can this go on?" I honestly don't know, but I *do* know that it can't go on forever. Nonetheless, history may give us some insight as to when the next crash *may* occur.

All clients of ours should by now be familiar with the chart on the next page: the Fed Funds rate. The very same rate that those super smart people around the fancy table tinker with. In many ways, this is a very revealing chart.



Notice that there are some grey lines running vertically. These lines represent "recessions," but to you and me they are market crashes. Notice what occurs just before a grey line. There is no grey line that is not preceded by an increase in rates, and no grey line that does not have a blue line running down diagonally through it. Take a minute and look for those two things. What do they reveal?

With some close analysis, here is what we can deduce:

1. No market crash occurs without the Fed first raising rates.
2. When the Fed starts raising rates, they do not stop until the market crashes.
3. The Fed does not lower rates until after the market crashes.
4. The rate needed to crash the market in 2000 was about 7%.
5. The rate needed to crash the market in 2008 was about 5%.

The rate needed to crash the market the next time will likely be less than 5%, possibly as low as 3%

Ask yourself this question: Why would the Fed raise, and then so quickly and drastically lower rates? Does that make any sense? Would you not agree that lowering rates so quickly after raising them would imply that they were raised too much or too soon, or perhaps both?

Partially. But the real crime was to lower them in the first place, to provide artificial stimulus. But no amount of intellectual discourse or high-minded sermons here will change the fact that we work for dollars, we save dollars, we spend dollars, and we give them away to eager recipients. This is the economy within which we must operate.

So what can we do with our knowledge of the past and how Fed manipulation has affected our economy?

They say the first step to surviving a mine field is to simply know of its existence. Some people are so afraid of the mine field that they stay inside, practically imprisoned, and eventually starve. These people today are sitting in cash, earning next to nothing, eagerly hoping that they will once again earn decent interest on their savings, but really will lose a good portion of their prior spending power.

And if our extrapolation of history is anywhere near being correct, it is highly unlikely that we will ever see 4% before the Fed lowers rates again. Why? Because a crash will have occurred.

Does that mean we should flee to cash? Or sit there for another eight years? Or wait until the economy is "acting normal" before we invest in stocks?

No. For several reasons:

1. There is really no stock bubble yet. History has shown that price/earnings ratios are generally much higher in the "bubble zone." Right now the bubble is in the bond market. Bond price/earnings ratios are definitely in the "bubble zone".
2. There is almost $10 Trillion languishing in cash. As stocks move higher, the herd mentality will take over and others will pile in, driving prices ever higher.
3. Money left in cash will lose more value as inflation accelerates.
4. The Fed will continue to raise rates until the market crashes. And history has shown that the markets do well as the Fed raises rates—to a point.
5. Dow 20,000 will be a psychological milestone to inspire more investment.

Therefore the wisest course seems to be to stay invested in stocks and real estate while eschewing bonds with lower quality and longer time to maturity. In the bond blood bath that is to come, these will be affected more drastically.

And as rates rise, our plan will be to ease out of the market and sit over in the shade, high and dry, safe and sound, in the only asset class to actually do well in 2008, when everything else was burning at the stake.

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About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through Voya Financial Advisors (member SIPC).

About Magellan Planning Group

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- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

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