Meet the New Boss – Same as the Old Boss

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

March 21, 2014—You've probably been hearing the name Janet Yellen a lot lately, and so I wanted to speak briefly about the new chair of the Federal Reserve and discuss the role she plays in global financial markets. It is useful to understand the major functions of the Fed and why they mean something to you as an investor.

Janet Yellen replaced Ben Bernanke as Chair of the Board of Governors of the Federal Reserve System on February 3, 2014 and will serve for a four-year term. In plain terms, Ms.Yellen will determine the direction of arguably the most powerful central bank in the world and has the authority to make changes to monetary policy that will ripple across the global financial system.

The Federal Reserve System (known informally as the Federal Reserve or the Fed) is principally made up of 12 regional Federal Reserve Banks, a presidentially appointed Board of Governors, and the Federal Open Market Committee. While the Fed is responsible for duties like regulating the Federal Reserve Banks, administering credit protection laws, and monitoring the nation's payments system, its most important (stated) role in markets is to analyze global financial and economic developments and determine U.S. monetary policy.[1]

Let's back up for a moment and return to Economics 101. In the U.S., fiscal policy—the way the government spends money—is made by the federal government and is determined by each year's federal budget, which is proposed by the president and passed by Congress.

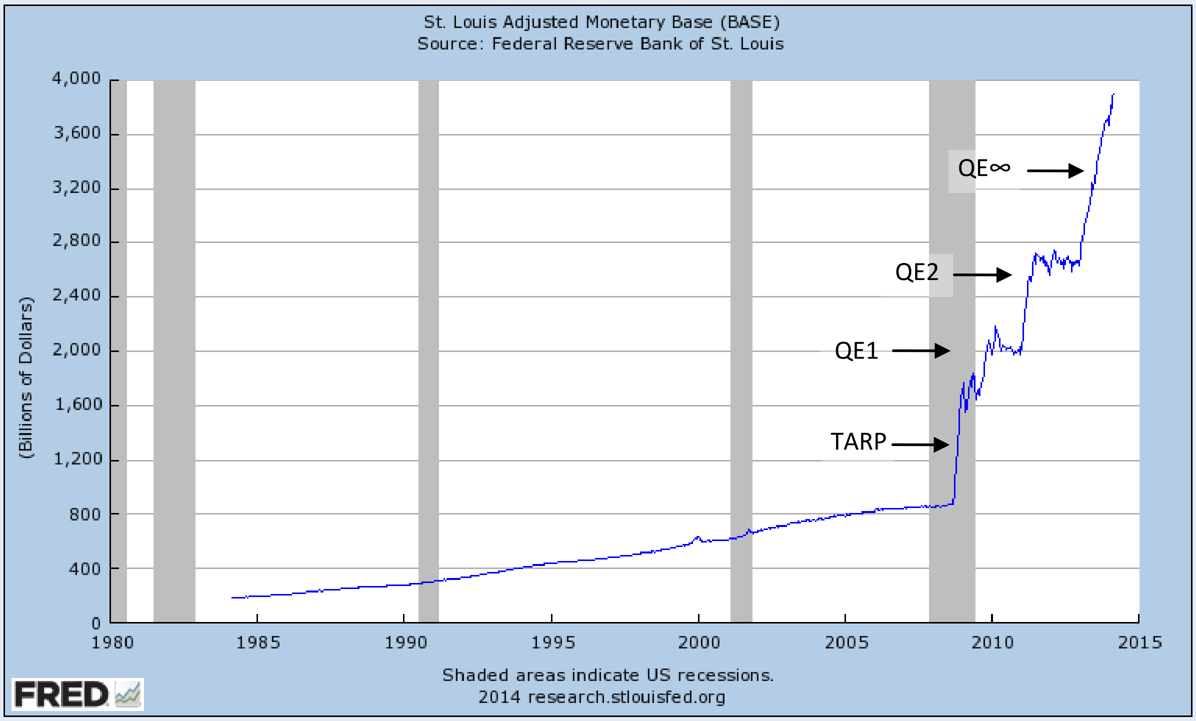
Monetary policy—interest rates and money creation—is developed by the Federal Reserve and is used to achieve macroeconomic policy objectives like inflation control (through price stability), full employment, and stable economic growth. Of course, that's the proffered theory.

While the Federal Reserve System is considered an independent central bank and makes decisions independently of Congress or the White House, the Fed is subject to congressional oversight, and Congress has given the Fed the "dual mandate" of achieving maximum employment and maintaining stable prices.[2]

The principal tool of the Fed's monetary policy is the Federal Open Market Committee (FOMC) a group within the Fed tasked with overseeing open market operations (i.e., the Fed's buying and selling of U.S. Treasuries and other securities in financial markets). As chairman of the Fed, Yellen now heads up the FOMC and wields considerable authority over its decision-making process. This committee meets throughout the year and decides how to achieve short-term objectives like interest rate targets through their bond-buying operations. Part of Yellen's job is to ensure that FOMC operations support long-term Fed objectives like economic growth, stable inflation, and high levels of employment. [3]

If you've been reading my letters over the last few years, you know that the FOMC undertook a program of bond-buying known as quantitative easing (QE) that was designed to lower interest rates (making it cheaper to borrow money), and boost economic activity.

Now that the economy is on more solid footing, the FOMC has been tapering its historically high pace of bond purchases and slowly returning to normal operations.



The chart above represents the Monetary Base, which is not the money in circulation, but the base amount of money that's been *created*. Most of this money is still being held at the Fed, which is why we have yet to see a corresponding increase in inflation.

Note the relatively gentle slope up until the 2008 financial crisis, when the Fed created TARP, QE1, QE2, Operation Twist, and currently, QE Infinity.[4] Prior to 2008, our monetary base was just over $800 billion. Note that today, roughly six years later, the monetary base is approaching a whopping $4 trillion. This is an increase of over 400%.

By law, the chairman of the Board of Governors must report to Congress twice annually on the Fed's activities and monetary policy. As the new chair, Yellen testified last month before the House Committee on Banking and Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs to outline her vision for the Fed and answer questions about Fed activities.

Yellen's testimony before the House and Senate didn't yield any shockers, and she stated that markets should expect the Fed to follow the low-interest-rate path laid out by her predecessor Ben Bernanke. Since Yellen served on the FOMC under Bernanke, this isn't unexpected. She also emphasized that the Fed would continue to taper asset purchases so long as the economy continued to improve and that future decisions would be very data dependent.[5] We know that the Fed is carefully monitoring employment reports, and they say they intend to keep rates low even if the target 6.5% unemployment rate is reached.

In truth, the Fed has no other option but to keep rates low, since rising interest rates on our massive $17 trillion debt would crush our already overstretched budget. Speaking of, President Obama just released the 2014 Fiscal Budget of $3.9 trillion—half of which will be paid for with more debt. This is like planning to use your credit card to pay for half of your monthly expenses, never worrying about when, who, how, or even if it's ever paid back. It's a terrible legacy to leave our children, when after World War II we emerged as the world's greatest creditor. Now we are its greatest debtor.

You may know that one of our favorite indicators as to whether the macro-economy may be moving to all new highs or whether there is potential for a crash, is the simple yet crucial factor of monetary policy and credit expansion or contraction.

Austrian economists explain that markets (stock prices) will run as the money supply increases. Over time, this creates inflation, which causes central banks to reverse the expansion. Once contraction ensues, history has proven that it is simply a matter of time before a correction occurs.[6] This knowledge served many of our clients in helping them better prepare for the corrections in both 2000 and 2008.

Economists widely expect Yellen to continue tapering while leaving interest rates at the current all-time lows. Thus, it would appear that we are still in expansion mode, though perhaps not at previous levels.

I know the market looks scary at times, but with nearly $9 trillion sitting in cash, and the Fed pumping new money into the system every minute, we feel confident that the human condition known as greed will eventually wear down the resistance of those still stuck in the human condition known as fear. Many people still stunned with fear after 2008 are still sitting in cash, and as stocks go ever higher, some of these people are likely to move out of cash back into stocks and real estate in order to capture some of the gain that they've missed out on. This could very well drive the market ever higher, perhaps even to unreasonable levels.

Since Yellen has indicated that she will continue Bernake's infusion of ever more "stimulus" for the foreseeable future, the game for the government now is to spin administrative numbers to try to convince everyone that inflation is not really occurring. If it were, the Fed would have to raise rates, and we all know they can't do that. By this time next year, if we continue on this current path, we will be approaching $20 trillion of debt. From our perspective, there is nothing on the horizon to dramatically change this any time soon.

Nevertheless, we must always heed the words of the great Austrian Economist Ludwig von Mises when, back in 1944, he said…

> *True, governments can reduce the rate of interest in the short run. They can issue additional paper money. They can open the way to credit expansion by the banks. They can thus create an artificial boom and the appearance of prosperity. But such a boom is bound to collapse soon or late and to bring about a depression.*[7]

Sound familiar? Thus, in keeping with Professor Mises and Austrian Economics, we are optimistic in the short run, we are cautious in the middle run, and down right defensive in the long run.

As always, if you are concerned or unsure of your prospects for the current boom and the coming bust, simply contact my office to schedule an appointment. Remember, in the words of JFK, the best time to fix the roof is when the sun is shining.

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Google Finance is the source for any reference to the performance of an index between two specific periods.

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[1] http://www.federalreserve.gov/monetarypolicy/default.htm
[2] http://www.federalreserve.gov/faqs/money_12855.htm
[3] http://www.federalreserve.gov/faqs/money_12855.htm
[4] http://research.stlouisfed.org/
[5] http://www.marketwatch.com/story/yellen-stresses-continued-low-rate-policy-2014-02-11?link=MW_latest_news
[6] Compare Fed Funds rate with S&P 500 price movement since 1950. http://research.stlouisfed.org/
[7] Ludwig von Mises. Omnipotent Government, 1944.