Rodney's Take

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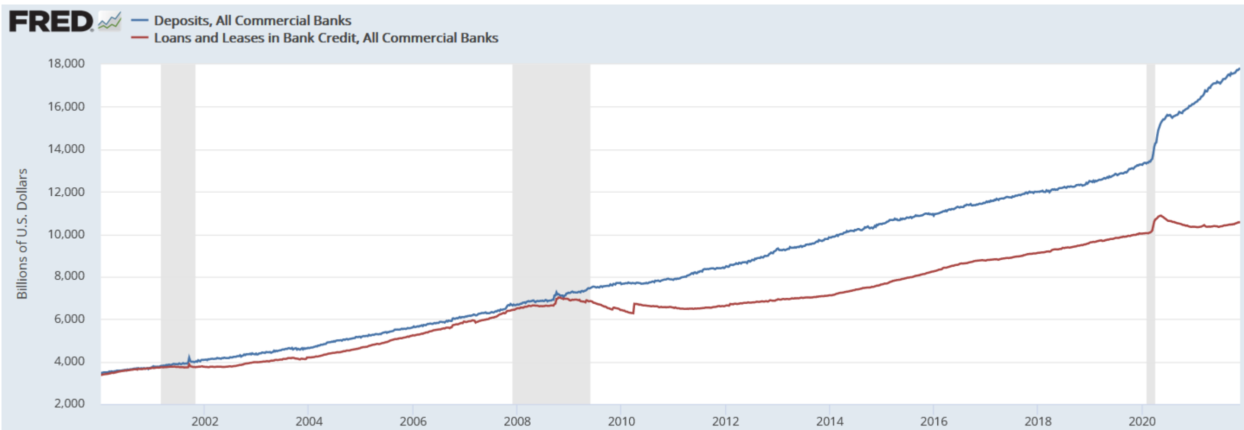
The Fed Is Out of Touch, But It Still Has a Bite

The unemployment rate was a mere 3.5% just before the pandemic in February 2020. Eight weeks later it shot up to 14.8%, delivering a body blow to the economy. Over the next several months, millions of people left the workforce while others found new jobs, so the unemployment rate dropped 8.4 in August 2020. That's when Fed Chair Powell announced that the central bank would prioritize maximum employment over moderate prices. The bankers made a conscious choice to overheat the economy to get as many people from different socioeconomic backgrounds back to work as quickly as possible.

It worked, but not because of the central bank.

The Fed continued to add financial fuel to the fire, but the big economic push came from the federal government, which tacked on two more stimulus programs. The unemployment rate dropped to 6.3% in January of this year and now sits at 4.2%, a mere 0.7% higher than before the pandemic. We can quibble that people who left the workforce also reduced unemployment, but help-wanted signs in windows across the nation and signing bonuses at fast-food joints show that jobs are out there.

The hiring boost came courtesy of outsized demand, which was courtesy of Uncle Sam. Little if any of it came from increased borrowing due to low interest rates, which is how the Fed transmits monetary decisions into the broad economy. The Fed gave up this power in 2008 when it gained the ability to pay interest on excess reserves (IOER), which allows banks to earn interest on deposits that sit on their balance sheets instead of being lent. The chart below, which compares commercial bank deposits in blue to loans outstanding, tells the tale.



The two lines ran close together until the Great Financial Crisis, but then deposits continued to climb as loan growth lagged. During the pandemic, deposits soared but loans popped, declined, and then went sideways.

The Fed's ultra-low interest rate policy clearly is helping the housing industry through low-cost mortgages, but outside of real estate, the Fed isn't nearly as relevant to the broad economy as the central bankers seem to think. GDP growth will ease in the months and years ahead not because the Fed raised rates or bought fewer bonds but because the federal government (we hope) didn't borrow and distribute trillions more dollars to individual consumers.

But this doesn't mean Fed actions have no effect. While monetary policy doesn't sway consumer and business behavior like it did in years past, it still packs a wallop when it comes to the financial markets.

Exceptionally low interest rates drive investors up the risk scale to meet their investment goals, which pushes up the value of equities. The higher they go, the more money they attract. As the Fed reduces bond purchases and eventually raises rates, it should take some wind out of the sails of high-flying stocks and lead investors to refocus on dividend-paying equities.

One class that could feel a lot of pain is closed-end bond funds, which borrow short-term cash to leverage their investments. Higher short-term rates increase the cost of borrowing, and if long-term rates move up, then the bonds held by such funds will drop in value, creating more financial pain.

As for fighting inflation, the Fed can't stop what it didn't create. We turned our attention to goods when we were shut out of buying services and created a demand/supply imbalance. This eventually will work itself out as the extra cash in the system fades. It has nothing to do with the Fed, but they'll claim credit anyway.

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Got a question or comment? You can contact us at info@hsdent.com.