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Not Your Parent's Federal Reserve

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Whether one likes it or not this Federal Reserve, under the direction of Chairman Ben Bernanke, has not exactly been shy in turning traditional Fed actions on their collective head. Another major development occurred on January 25.

The Federal Reserve—now in its 99th year of existence as this nation's central bank—has traditionally tried to keep financial market players and investors in the dark as to future policy moves. As a result, major financial institutions for years employed highly compensated "Fed watchers" to decipher every word…every nuance…of Fed statements to gain an advantage regarding the Fed's next monetary policy moves…

Ben Bernanke

…needless to say, those positions no longer have value

Note that the Fed had reduced its key short-term interest rate (the federal funds rate)… and the most important of all short-term interest rates…to an all-time low target range of 0.00%-0.25% in December 2008, more than three years ago. The Fed had suggested in 2009 and 2010 that it was in no particular hurry to push that rate higher.

Last August, the Fed then took the unprecedented step of indicating that the rate would stay where it was "until at least mid-2013"…unlike any statement the Fed had ever made before. The Fed's intent was to allow businesses and consumers to have some clarity or relative certainty that new loans or new borrowings could be undertaken with limited upside interest rate risks.

That was then…this is now

The Fed's Open Market Committee (known affectionately as the FOMC) took that one better on January 25 with a statement that the federal funds rate would stay at its current historic low level "through at least late 2014." Another 18 months of incredibly low interest rate stability seems in store for the U.S. economy.

Note that this is a most likely scenario. Between you and me, the Fed would love to see stronger-than-expected U.S. economic performance this year and next year and the following year, perhaps mandating a move to push its key rate higher sooner rather than later.

A GDP Forecast

In reality, the Fed's willingness to keep its key rate so low for so long is a recognition that modest U.S. economic growth of 2010 and 2011 is likely to continue. The Fed's January 25 forecast of 2.2%-2.7% real (after inflation) U.S. economic growth this year is down from a forecast of 2.5%-2.9% growth last November.

The Fed expects real U.S. economic growth in 2013 of 2.8%-3.2%, also down from a prior forecast. Its forecast of as much as 4.0% real growth in 2014 seems quite iffy… and in my mind only occurs with a much more business-friendly Administration and Congress than the one we have now.

An Unemployment Rate Forecast

The Fed also provided its collective forecast that the current 8.5% unemployment rate would be no lower than 8.2% at year-end. It also suggested a jobless rate of 8.1% down to 7.4% in 2013 and a rate of 7.6% down to 6.7% in 2014. Again, my view would require a massive sea change in government to reach those more attractive levels.

The nature of the FOMC's forecast was different this time around. This is the first time the Fed has published such detailed predictions by its senior officials about future policy decisions *(The New York Times).*

An Inflation Forecast

The Fed's FOMC also for the first time publicly acknowledged a target of 2.0%

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for inflation, as measured by the Fed's personal consumption expenditure index (PCE deflator). This inflation measure differs slightly from the more familiar Consumer Price Index. This goal of roughly 2.0% inflation has been widely accepted by financial markets—but never actually articulated by the Fed until now.

More QE?

In addition to pushing its key interest rate to historic lows in recent years, and promising to keep it there for a long time to come, the Fed has been throwing mud at the wall through a process called "quantitative easing." The Fed announced and enacted two major moves of buying roughly $2 trillion of mortgage-backed securities and U.S. Treasury securities in an attempt to push long-term interest rates lower. The FOMC suggested in a very complex statement that more bond buying is "an option that's certainly on the table."

By the Fed's measure, the process has been successful. Thirty-year fixed-rate conventional mortgage loans averaged 3.88% the week of January 16-20, the lowest level on record.

One might think that such incredibly low fixed-rate conventional mortgages would draw record levels of home buying and refinance activity. Such is not the case. Home sales remain soft (although improving), while refi-activity is not exactly gangbusters.

The headwinds of roughly one out of every four homes being underwater (the mortgage is larger than the current value of the home); still high unemployment; and the latest bombardment of government legislation on lending institutions…the more than 2,300 page Dodd-Frank financial legislation…has made the lending process more cumbersome, more paper intensive, and more difficult. As noted before, just one more example of "we're from the federal government—and we're here to help you."

Savers Anguish

While the Fed's announcement can be construed as good news for businesses and consumers that are net borrowers, it is simply more pain and anguish for net savers. Millions of retirees had done all the right things over the years…investing in stocks and then shifting to bonds and certificates of deposit in later years.

Millions of retirees assumed a reasonable level of interest income from FDIC-insured financial institutions that would essentially be risk free (allowing them to sleep at night), while providing a consistent flow of income…

…not so fast

The Fed's continuing efforts to "help" the U.S. economy by keeping short-term interest rates extraordinarily low is significantly offset by a shrinkage of spending by retirees on housing, trips to restaurants, entertainment, travel, etc. as incomes for millions are sparse. Now more of the same for *another* 18 months!

Unfortunately, too many retirees are reaching for higher returns by putting money into higher risk "deals" that will ultimately cost them dearly. Note: At lunch a couple of days ago, a roughly 65-year-old man was telling a younger woman, a daughter I think, about this "great investment opportunity" that he had been shown by a near stranger. He was explaining how high quality it was even as the returns were very high…

…a fool and their money are soon parted

Always remember…if it sounds too good to be true…it is!

Jeff

"TEA"ser

There is a great need for a sarcasm font.

From Scott Friedman

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