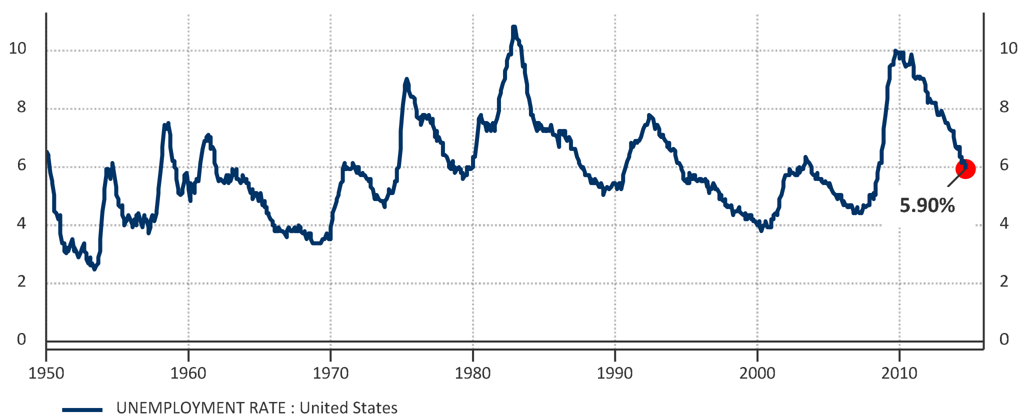
Martin Capital Partners

Quarterly Point of View
Impolitic Fed

October 24, 2014

The Federal Reserve is heading down two potentially ominous roads, both driven by overconfidence in their own abilities and view of their mandates. The first road is ZIRP (zero interest rate policy), which has been in place since 2008 and poses the risk of staying too loose for too long, and the second is a slow and subtle morphing of the institution itself, into one with greater power and influence than originally granted.

Regarding interest rate policy, it is troublesome that the Fed appears to be complacent to the long run potential risks of staying too accommodative for too long, as they try to squeeze every ounce of employment potential from the ZIRP turnip. The Federal Reserve has a dual mandate to promote the goals of maximum employment and stable prices. 'Maximum employment' is difficult to define – but the unemployment rate as illustrated by the household survey dropped to 5.9% – well below peak unemployment of 10.1% during the financial crisis and even below the measurement's 50 year average[1]. It is also under the 6.5% level that former Fed Chairman Ben Bernanke targeted as the point to begin tightening. Current Chairwoman Janet Yellen believes it's more complicated than that however, and feels other measures now need to be evaluated.



Source: Thomson Reuters Datastream, Martin Capital Partners, LLC

Though not a desired unemployment rate, it most certainly falls in the 'normal' category when looking back over the last half century. As Richard Fisher, President of the Federal Reserve Bank of Dallas noted recently, "The economy is reaching the desired destination faster than we imagined."[2]

On September 17th the Federal Reserve said it would end the bond buying program, referred to as quantitative easing (QE), in October but reiterated its guidance that short term interest rates would remain near zero for a *considerable* time. The Fed stated specifically, "It will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends."

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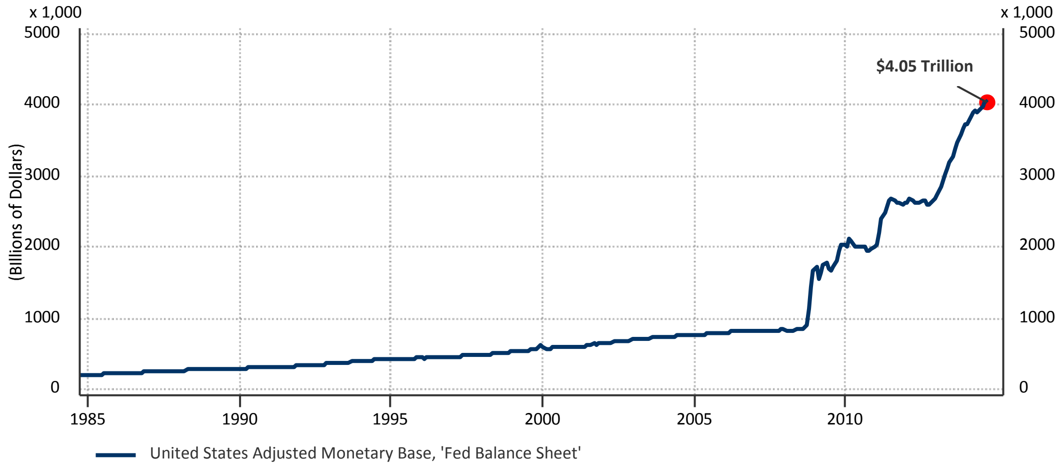

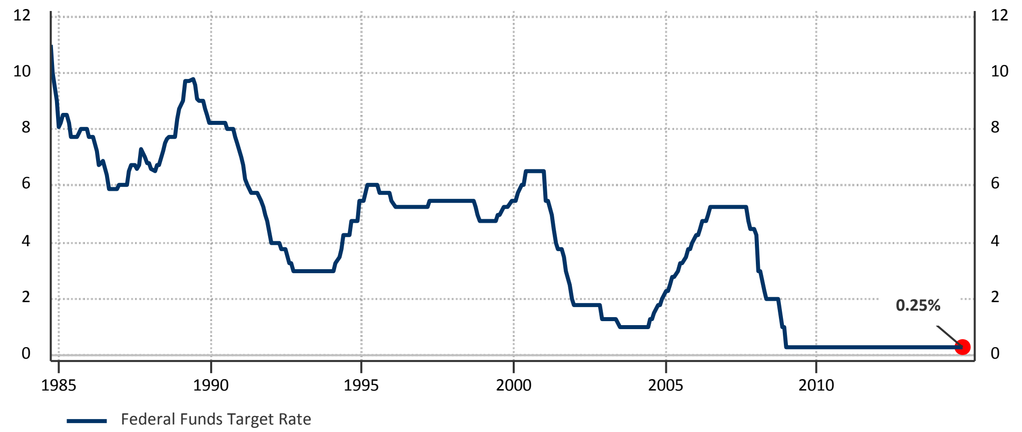

Source: Thomson Reuters Datastream, Martin Capital Partners, LLC

The Fed has to ask itself - what is more 'out-of-the-norm', the condition of the economy, or our policy to address it? We think the answer now is without a doubt, the Fed's policy. If that is true, then any benefits the economy might see by a continually hyper-accommodative monetary stance are not commensurate with the risks of a prolonged out-of-the-norm policy. Apparently, the Fed does not see it that way and appears willing to maintain abnormally low interest rates because the U.S. hasn't reached so-called full employment. Fed policy has now been easy for almost 6 years, so it can no longer be argued that it is being used as a short term tool. Artificially low interest rates for extended periods like this will distort decision making thereby creating long run, unintended consequences.

The other dangerous road the Fed is traveling is one littered with power potholes and moral hazard, and is much more important than any current economic report. The Federal Reserve was created in 1913 to provide the nation with a safer, more stable monetary system. With the Federal Reserve Reform Act of 1977, the mandate was re-formulated to include the dual goal of promoting maximum employment and price stability. Now the boundaries are getting blurrier. An institution that once upon a time very rarely intervened in financial markets, the Fed continues to push its limits with apparently no pushback from Congress. Janet Yellen and other central bankers are in the process of adopting new economic management techniques under the guise of *macroprudential* regulation. In other words, means of attempting to manage and reduce systemic risks through regulating financial system behavior. This has been a steady and consistent argument by Yellen's Fed - that growing this power is necessary for economic stability. Brian Wesbury, Chief Economist at First Trust effectively summarizes it this way:

For example, in 2004-05, the Fed held the federal funds rate at 1% which helped cause a bubble in housing. But, rather than raising rates at that point, the Fed wants to have the right to regulate home lending activity. It could do this in any number of ways, by raising the capital required by banks to make home loans or possibly putting a limit directly on certain types of loans. That's macroprudential regulation. In effect – and the Fed has argued this – the Fed blames banks for bubbles, not its strategy of holding interest rates artificially low. This is central planning to the second degree. The Fed wants to set rates first and then police the impact of those rates as if these decisions are not related. This is a very dangerous precedent and it moves the U.S. away from the free market while continuing to concentrate the power in the hands of the Fed. In a true free market, monetary policy should not be used to manage the economy. Rather, monetary policy should have one goal – to keep the value of the currency stable.

This is a worrisome path the Fed is traveling - believing they can hold interest rates at zero for lengthy periods in an attempt to attain one goal, and at the same time thinking they can control the associated risks of that easy money by using 'behavior' regulation tools. Beyond considering the fact it's silly to think the Fed could pull off this type of balancing act, it's what it reinforces to the capital markets and investors – that the Fed is there as at every turn… Go ahead, is the implication; feel free to make woefully considered allocations of capital, we'll just be right here to 'manage' it when it gets to a hazardous level. It's simply absurd.

There is no doubt the Fed is under considerable stress not necessarily of its own making. Elevated by the political system's failure to address broader fiscal challenges, the burden on monetary policy despite its inherent limitations, is enormous. Given recent fears of slowing global growth and capital market weakness this view may be considered too black and white, and some would say now is the time instead to use an extra degree of caution. But there are always current issues to worry about - that's the nature of economies and markets - the policies in place were designed for a near apocalyptic financial crisis, not as a structural fixture.

Taking the first step is clearly the hardest, and removing the ZIRP medication will come with its own price, but that price will continue to rise until policy starts to normalize. The Fed would be wise to begin this process by raising interest rates sooner rather than later, and become sincerely reacquainted with its historical mandates.

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It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

Statistical and analytical data provided by Thomson Reuters
1. Bureau of Labor Statistics, Martin Capital Partners, LLC.
2. Wall Street Journal, 27 July 2014.

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