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NEARLY TEN YEARS SINCE THE FEDERAL RESERVE LOWERED THE FED FUNDS RATE TO 0%

5/16/17

This is the ZLB, or zero lower bound. The Fed been very anxious to get off the ZLB, if for no other reason, so it can lower rates if the economy weakens. Conventional economic theory suggests that interest rates cannot fall below 0%. We now know this isn't true, but what we don't know are the effects of negative interest rates. After reaching the ZLB and in light of a very weak recovery, high unemployment, and low inflation, the Fed was hesitant to raise rates. Instead it tried what it now calls "Unconventional Monetary Measures". This meant Quantitative Easing (QE) and Forward Guidance. QE involved buying bonds from the Private Sector and paying for the bonds with newly created Fed money. This new money, along with lower interest rates, was supposed to fuel a pickup in economic activity. During the bond buying periods of QE 1, 2, and 3 when long-term interest rates were supposed to go down, they went up. When the Fed discontinued their purchases after QE 1, 2, and 3, rates were supposed to go up. They fell. Not exactly the plan. Next came Forward Guidance. Forward Guidance is nothing more than carefully crafted speech designed to cause the Private Sector to act in a way that helps the Fed achieve its goals. Federal Reserve transparency is noble, but is it effective? The unintended consequences of telling investors interest rates will stay "lower for longer" may have contributed to increased confidence and poor investment decisions (buying stocks on margin). The infamous "Dots", or projections of future rate Increases by Federal Reserve Members as well as projections of GDP, unemployment, and my favorites, "inflation is moving toward our target" and "disappointing first quarter GDP is 'transitory'", make me question the effectiveness of Forward Guidance.

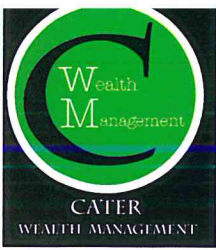
Let's look at the record:

First Goal: 2% Inflation

The Fed's preferred measure; the core PCE deflator hasn't hit 2% since the GFC (Global Financial Crisis). The latest reading is 1.83% in March 2017. It actually fell in March.

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Second Goal: **Jobs**

While the unemployment rate has declined from double-digit levels to 4.4% in the latest report, let's instead look at job creation as measured by the monthly Jobs Report.

| Year | Average Monthly Jobs created | % Change |
|-----------------|------------------------------|----------|
| 2014 | 248,000 | |
| 2015 | 225,000 | -9% |
| 2016 | 180,000 | -20% |
| 2017 (3 months) | 171,000 | -5% |

In addition to generating fewer jobs each month, we are losing manufacturing, and gaining leisure and hospitality jobs. In his Bloomberg View note dated 5/16/17, Dr. A Gary Shilling explains that weekly pay of the lost manufacturing jobs is 2.69 times greater than the leisure and hospitality wages replacing them.

The Fed has raised the Fed Funds rate 3 times **since 2015**; the effect on long-term rates has been ZERO. From the first increase through today (12/16/2015 - 5/16/2017) the 10 year treasury rate has moved 2 basis points, 2.30% to 2.32%.

The next big thing in the news is the timetable for shrinking the Fed's balance sheet, the "new" Forward Guidance. Prior to the GFC, the Fed balance sheet was approximately \$850 Billion. Today it is approaching \$4 ½ Trillion. QE is responsible for most of the increase but not all of it. The Fed's balance sheet has to be large enough to support all of its liabilities. In 2008 its largest liability was currency in circulation, \$800 Billion. Excess Reserves, Treasury deposits, and all the other liabilities were very small compared to today. Excess Reserves alone have grown from \$10 Billion to \$2.5 Trillion! The Fed wants to "normalize" the balance sheet, whatever that means. Just like when it wanted to normalize rates. Some very smart people like former Fed Chairman Ben Bernanke recently said, "there are reasonable arguments for keeping the Fed's balance sheet large indefinitely" (Brookings 1/26/2017). Zoltan Pozsar also said, "we see very little room for the Fed to ever shrink its balance sheet" (Global Money Notes #5, Credit Suisse).

We care about all of this because **we care about interest rates**. I believe **rates will stay low**, not because of what the Fed does or doesn't do, but **because inflation will remain low**.

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