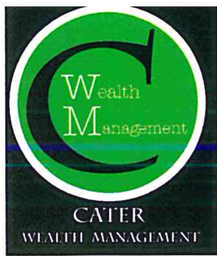

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Greg Cater Sr. and Greg Cater Jr.
Did The Fed Finally Get It?
2/6/19

For the last 3 years the Federal Reserve FOMC feared that a tight labor market would cause inflation to soar. Their response was nine straight 25 basis point increases in the Fed Funds Rate.[1] The thought was that higher borrowing costs would slow down economic activity, and they wanted to get out in front of this inflation threat. Their second point of attack was the Balance Sheet. A reduction in the $4.5 Trillion Balance Sheet at the Fed would reduce liquidity further and help the cause.[2] Last December Jerome Powell, Chairman of the Federal Reserve, went so far as to say the plan to reduce the Balance Sheet was "on autopilot".[3] This led many to believe it was not subject to debate. We disagreed then and we disagree now. Let's take a look at the Fed's dual mandate of maximum employment and price stability.

Prior to 2012 the Federal Reserve had only one mandate, maximum employment. The Great Financial Crisis of 2008 resulted in double-digit unemployment, the highest since the Great Depression. The now going on 10 year economic expansion has brought the unemployment rate down to a very low rate (3.7% at the low).[4] Why is low unemployment a bad thing? Don't we want people working? Well, most decision makers at the Federal Reserve are trained economists. All economics majors learned about the direct relationship between unemployment and inflation shown by the Phillips Curve...or did they? The noted economist, William Phillips, published a paper titled, "The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957".[5] Somehow over the years Wage inflation became Consumer inflation. They are not the same. Employers are reluctant to raise wages because it is very difficult or even impossible to lower them later. Wages are "sticky". Have you ever taken a pay cut? Employers only raise wages if workers are more productive. More productivity means more output. If wages and output both move up at the same rate where is the inflation? If you agree with Milton Friedman who said "inflation is always and everywhere a monetary phenomenon", or in normal English; inflation is the result of the amount of money available to buy things and the amount of things out there to buy, it's easy to see why higher wages don't necessary lead to higher inflation. I find it very interesting that the very same government agency we get the monthly unemployment numbers from, The Bureau of Labor Statistics (BLS), was around and publishing unemployment statistics in 1929.

The unemployment rate for 1929 was 3.2%, which is lower than today.[6] Did we have soaring inflation in the 1930's?

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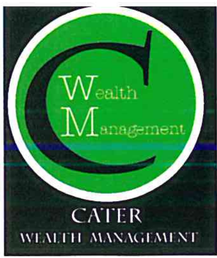

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Raising interest rates to prevent future inflation before you see inflation rising may not be wise. Let's now turn to the Federal Reserve's second mandate, Price Stability.

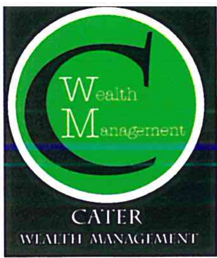
On January 25th, 2012 the Fed decided:

"The inflation rate over the longer run is primarily determined by monetary policy, and hence the Committee has the ability to specify a longer-run goal for inflation. The Committee judges that inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with the Federal Reserve's statutory mandate."[7]

According to Bloomberg, the year over year change in the Fed's preferred measure of inflation has surpassed the Fed's target only 7 out of 83 months. The current rate is 1.8%, it never exceeded 2.6% and has averaged 1.4% over close to 7 years.

So let's recap. The Federal Reserve has two mandates; maximize employment and maintain stable prices. In the past, these mandates were seen as a balancing act, with high levels of employment supposedly causing prices to rise, or inflation. Since 2015, the Fed has been afraid that low unemployment would cause unwanted levels of inflation, and has been trying to preemptively combat this by decreasing its balance sheet and raising the Fed Funds rate. The only problem is, even with unemployment at record lows, inflation is nowhere to be seen. A recent Fed paper issuing a stunning about-face regarding policy; stating that the members agree that a halt or even increase in the balance sheet, or a halt or decrease in the Fed Funds rate may be warranted in the future, leads me to believe that the Fed has finally caught on to the idea that we are not in an overly inflationary environment, regardless of what the unemployment numbers say.

So what does that mean for investors at Cater Wealth Management? All of this information serves to reinforce our belief that interest rates are headed lower over the long run, and securities that yield income tend to perform well when interest rates decline.



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