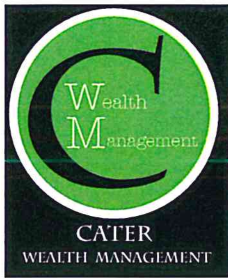

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TODAY'S INTEREST RATES

This week the Federal Reserve decided not to raise interest rates. This was the right decision for the right reasons, although most disagree. We hear every day we must normalize rates. Those who say this assume normal means higher. If we still believe supply and demand determine price and the price of money is reflected in the cost to borrow it, normal means lower, not higher.

Today, September 25, 2015, fed funds are trading at 14 basis points, well below the Fed's 25 basis point target. I've often wondered why anyone would lend funds at .14% when they could just leave the money with the Fed and earn .25%. The answer is not everyone has access to IOER. Interest on Excess Reserves is only payable to commercial banks that have reserves deposited at the Fed. Other institutions that participate in the Fed Funds market can only get the rate the market will pay (.14% today).

$2 ½ Trillion in Excess Reserves

Prior to the 2008 Financial Crisis banks managed their reserve balances carefully. Excess Reserves were expensive. The Fed did not pay IOER. Well capitalized banks didn't worry about reserves requirements. The Federal Reserve System is charged with ensuring the nations banks have access to required reserves. If a bank finds itself short of reserves it has options. It can accept an automatic overdraft from the Fed or it can "buy" reserves from another bank. It will usually choose the cheapest option. Either option is usually more cost effective than hoarding Excess Reserves earning 0%. Three rounds of QE (Quantitative Easing) have resulted in $2 ½ Trillion of Excess Reserves. If the Fed stopped paying IOER the banks holding these reserves would try to lend them, this increased supply of reserves looking for a home would push the Fed Funds rate lower. Most believe the Federal Reserve is using extraordinary measures to keep rates artificially low when in fact the Fed's actions are keeping rates artificially high.

The Fed's previous actions have created the $2 ½ Trillion in Excess Reserves. This excess reserve position has made it extremely difficult for the Fed to control rates. Draining reserves to raise the cost (rate) won't work. This leaves IOER and Forward Guidance.

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The easiest way for the Federal Reserve to raise rates is to actually pay a higher rate (on IOER). The problem with this strategy is it's inflationary. Most believe the main reason for raising rates is to combat future inflation. This is usually the case. If an economy is overheating an increase in the cost of credit will slow it down and eventually cause inflation to slow. In past tightening cycles it wasn't the Fed paying the higher interest rates, it was the private sector. If the private sector's cost of credit increases, business activity will slow. Federal Reserve tightening usually results in recessions. This time it will be the Federal Reserve actually paying the higher rate, not the private sector. Milton Friedman is famous for saying "Inflation is always and everywhere a monetary phenomenon." Inflation is the relationship between the amount of money and the amount of good and services that can be bought with the money. If both grow at the same rate inflation will be 0%. If the money supply grows faster than the goods inflation will increase because more money will be chasing the same amount of goods. If the Federal Reserve pays money that is currently not available to buy goods and service in the private sector to where it is available to buy goods and services and the amount of goods and services doesn't change, prices will rise.

It's no wonder they are delaying "Lift-Off". This leaves "Forward Guidance".

Forward Guidance is nothing more than carefully crafted speech designed to influence private sector behavior. Have you been listening? Federal Reserve members are saying the current lack of inflation is "transitory" and is expected to move back toward their 2% Target. They are saying the economy is improving and the job market is back to normal. Maybe their right, maybe not. They do have a history of painting a somewhat rosy picture. If nothing else the Fed has been very consistent in its overly optimistic forecasts of growth only to have to revise them down when reality hits.

WHAT IS THE MARKET TELLING US ABOUT INTEREST RATES?

The market doesn't have an agenda; it doesn't care about "Forward Guidance". In the United States 1 month T-Bills are trading today at -0.03%. That's right, negative .03%. 3 month T-Bills are -0.02.

And they say the Federal Reserve needs to raise rates?

In Europe; Germany, France, Sweden, Switzerland and the Netherlands are currently being paid to borrow money for up to 2 years, Switzerland can borrow for up to TEN YEARS AT A NEGATIVE INTEREST RATE!

Do you still believe rates are going up?