


Why the Fed Does Not Want to Raise Rates

Quick Look

<u>Market</u>	<u>Next Expected Move</u>	<u>Month</u>	<u>YTD</u>
?			
DJI		<1.97%>	<0.26%>
COMP		<1.26%>	3.48%
SPX		<0.87%>	1.33%
Gold		<2.46%>	<0.08%>

As an aside, most of the founders (Hamilton being the most obvious exception) distrusted central banking due to the disastrous French central banking experiment run by John Law several decades before the US Revolution.

Of course, there is no ONE natural rate of interest. There would be many, one for each time period for which the cost of borrowing money would be determined by a free market after weighing the risks of lending such capital. Therefore, natural rates of interest exist for overnight, 6-month, 1-, 2-, 5-, 10- and 30-year periods, for example.

- After the first quarter the markets still look to be topping.
- We discuss reasons the Fed may not wish to raise rates about which the Fed itself has been less than forthcoming.

The reason for the trade cycle has been discussed many times in the *CJ Newsletter* (*CJ*), so we will only present the skeleton here. For the record, this theory is also known as the *Austrian theory of the trade cycle*. If you would like more details, please contact me and I'll be happy to provide them.

Foundational Concepts

In order to understand the argument that follows, there are two concepts that must be both understood and kept in the forefronts of our minds:

- The natural rate of interest
- The reason for the trade cycle

The trade (business) cycle happens because of manipulations of interest rates through governmental interference with the free market. In the modern world, this is often accomplished using a central bank, such as the Fed in the US.

Both concepts are part of Austrian economic theory, with the former postulate being foundational for the latter theory.

The natural rate of interest can probably be most simply understood as the rate of interest that would be determined by a free market devoid of ANY governmental interest rate interference. This is hard to imagine in today's world, but is the way most economies in history actually were, including the United States prior to the creation of the Fed in 1913.

One of Lord Keynes's great revelations to the economic world was that he observed (correctly, I believe) that when an economy is at the bottom of a depression (the proper economic term for the bust portion of an economic cycle), there is no natural force that would initiate a business expansion. Prior to Keynes, no one knew what the supposed force was, but economists reasoned that since business expansions eventually happened that one must have existed.

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"The market can stay irrational longer than you can stay solvent."

- Lord John Maynard Keynes

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Without a natural force to insure that economies would recover, Keynes reasoned that if the cost of money would be made cheaper (lowered interest rates) that it would stimulate a business expansion, instead of the economy being at the mercy of the fates. Keynes's reasoning is valid, but he *always* intended the government that lowered the rates to raise them after a short period, allowing for the extra assets on the central bank's books to be sold back into the economy and the normal (natural) interest rate to be resumed.

The Down Side of Keynes's Theories

That was where Keynes made his great misjudgment. Politicians wanting to be reelected can ALWAYS find a reason to pressure their central bank to keep interest rates low, because, after all, things are never perfect, are they? Thus, countries with central banks have been *continuously* (not temporarily) manipulating interest rates ever since Keynes's theory gave them permission to temporarily lower interest rates and reverse it later.

As an *important* aside, prior to Keynes, conventional economic theory always frowned upon governmental interference of any kind in the economy or monetary markets. Therefore, among the learned, there was no legitimacy to the government manipulating money supplies and interest rates. Knowing politicians, what *else* do you think happened because of Keynes's theories giving (even partial) legitimacy to something politicians had been dying to exert power over, but were unable to because it was out of line with conventional economic thinking?

Most politicians are, after all, a lower form of life. You can decide for yourselves just how low... But, what they did in 1937 and beyond was easily predictable. They glommed onto Keynes's theories as a means of legitimizing their exercising control over the economy as a dog would a steak. But, they had a problem. What would happen if economic fashion swung back in the other direction, once again de-legitimizing government interference in the economy?

(Channeling government thinking) We can't have that! How do we insure that we can continue to exercise this power *forever*? Hmmmm... I know! Why don't we use our power over the educational system to teach Keynesianism *exclusively* to our kids? They will grow up "*knowing*" that our manipulations and machinations are right and true and they won't question it any longer. If any university or school district disagrees, well, then, they just won't get all the government funds they are expecting.

It doesn't have to be true; it simply has to be *believed*.

Suddenly, due to the power of the governmental purse, Keynesianism "achieves legitimacy" from being the only type of economics taught. Governments don't even have to convince the populace any more – the citizenry will *believe* the government is merely performing its rightful function in such matters. By the early 1950's, the deed was done. Keynesianism was indeed the only "legitimate" form of economics and other economic theories developed over thousands of years, including the ones believed by our founding fathers, were relegated to dusty bookshelves in libraries and practitioners of those theories labelled "crackpots."

If you don't believe what you just read, we would like you to know we have some land just off the coast of Florida you may be interested in buying.

The Trade Cycle

There are four stages to the trade cycle:

- Business expansion
- Cycle peak or top
- Business contraction
- Depression

There are other terms used for some of these stages, with the largest number of them used to describe euphemistically the last two stages of the cycle – such as business slowdown and recession.

Business project decisions are evaluated based upon current business conditions. One of the most important of these conditions is the prevailing interest rate, which is the cost of borrowing capital. Interest rates are prime factors in the calculation of breakeven analyses, profitability analyses, and other project evaluation methods.

If the market rate of interest is actually determined by the market, these calculations are reasonable ways to evaluate potential success or profitability. Keep in mind that all such calculations involve assumptions that may or may not reflect the business conditions the new business or expansion will actually be facing. Additionally, business conditions change, which could impact the calculation had the changes been known beforehand.

The business cycle itself is caused by the intervention of a governing authority which attempts to manipulate interest rates in order to increase business activity for any reason – valid or not.

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Let's assume a government/central bank is attempting to increase business activity from a depression (recession) bottom, as envisioned by Keynes. Once the interest rate is lowered, business calculations involving the breakeven levels or profitability of business projects will provide false positive indications of business projects being profitable. Therefore, capital (from savings or borrowings) is put into undertaking both normal and marginal projects, increasing business activity, as expected.

Projects that have profits exceeding both the nominal and actual rates of interest (normal projects) will likely succeed, unaffected by the distortions of the nominal rate being less than the actual rate of interest.

However those projects undertaken whose profitabilities lie above the nominal rate of interest as controlled by the government, but *below* the actual (natural) rate of interest will eventually fail, because the *real* rate of borrowing capital is the natural rate of interest. We will refer to such projects as *marginal projects* for the rest of this discussion. We will also refer to the range between the natural and nominal rate of interest as the *danger zone*.

Obviously, the accelerated business activity is due to the creation of marginal projects that should fail, since their profitability calculations are not positive using the natural (real) rate of interest. However, in the short term there is increased business activity, creating the expansion or boom portion of the business cycle. But, their lack of profitability becomes clear later, especially if the government returns rates to market rates voluntarily or market rates return to more natural levels despite governmental interference.

Since an unnaturally large number of marginal projects were undertaken due to interest rate distortions, the failure rate of businesses will be unnaturally large in subsequent periods.

When the failure rate of the marginal projects exceeds the creation rate of new business projects, the economy will change direction from expansion to contraction, and the cycle will enter the third phase.

To long-term readers, much of this is review. However, let's consider what we just discussed under the previously unheard-of (in the US, anyway) conditions of a central bank undertaking a *Zero Rate Interest Policy (ZIRP)* for more than 6 years.

In the example above, the interest rate was assumed to have been reduced below the natural rate of interest by a relatively small amount – say reduced from 3.5% on

overnight money to 2.5% - with all the resultant changes rippling through the longer interest periods. This would create a population of marginal projects that would eventually fail, causing the economic boom eventually to turn to an economic bust.

But what happens if the rate is reduced to 0%?

The Scope Changes

The following discussion may be tedious, but it is important to understanding why governmental interest rate manipulations are not healthy for the economy in the long run.

In our example above, we assumed the following:

- Natural rate of interest = 3.5%
- Nominal rate of interest = 2.5%

Looking at the ZIRP, the nominal rate of interest would be 0.0%. So, the danger zone for projects likely to fail would change from 1% originally to 3.5% upon the use of the ZIRP – a much wider zone.

The assumptions below are purely assumptions, but they are internally consistent and valid conclusions can be made from them. They are also consistent with Austrian Trade Cycle theory and the applied math is accurate. Understanding how lowering nominal interest rates in smaller amounts versus using a ZIRP dramatically changes the percentage of total projects undertaken is critical to understanding what our economic future will most likely be like.

For purely the purposes of example, let's assume the following for a one-year period:

- Natural rate = 3.5%
- Nominal rate = 2.5%
- Projects undertaken exceeding the natural rate of interest = 100,000
- Marginal projects undertaken = 10,000
- Total projects undertaken = 110,000
- **Percentage of marginal projects = 9.1%**

Assuming the relationship is linear, those same assumptions under ZIRP appear like this:

- Natural rate = 3.5%
- Nominal rate = 0.0%
- Projects undertaken exceeding the natural rate of interest = 100,000
- Marginal projects undertaken = 35,000
- Total projects undertaken = 135,000
- **Percentage of marginal projects = 25.9%**

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The assumption of linearity may not be true, but it simplifies, for understanding purposes, the quantitative nature of altering the scope of the problem from implementing a ZIRP. The larger message gleaned from these assumptions is still valid.

First, using the example it is easy to see how lowering interest rates would increase total projects undertaken initially, prior to the eventual failures of the marginal projects. Clearly, more jobs, more business activity happens upon the initial stimulus of lowering rates. It's easy to see the attraction of this to folks who don't understand the long-term price to be paid – and to politicians whose idea of long-term means whenever the next election is.

Continuing our thought experiment, let's assume the failure rate of marginal projects to apply over time as follows: 1-year failures = 50%, 2-year failures = 35%, 3-year failures = 15%. Therefore, we can assume that all marginal projects that will fail from danger zone problems will have failed by the end of three years even with the lowered interest rate policy still active.

Assuming there are NO failures from the normal (non-marginal) projects group, the economy reaches a steady state of having added 16,500 projects in year 3 for the 2.5% interest rate and 57,750 added projects for ZIRP. Upon the removal of either lowered interest rate policy, the remaining marginal projects finish failing within 3 years and the economy is left with no lasting net project increase from the projects created with either lowered rate interest policy.

In other words, *in the long run, the marginal projects eventually add no lasting business expansion to an economy versus leaving it alone.* That's the *best-case* scenario.

Of course, we can't assume a 100% survival rate for the normal projects. Normal projects do fail, adding to the project losses from manipulated interest rate activity. Technology changes, fashion changes and host of supply and/or demand changes make it so that mostly nimble, forward thinking and well-managed projects will continue for long periods. Others will fail, even if initially successful, due to such changes.

The remaining issue in our thought experiment is hard to prove. I'm not sure how it could be measured for existence, let alone quantified. Still, it bears discussion. Our assumptions included a constant number of normal business projects undertaken each year. What if that is not the case? If we presuppose that there is only so much capital can/will be lent out in a given year, is it not likely that at least *some* capital best lent to the normal projects would in fact be partially misallocated to additional marginal projects beyond our assumed amounts? In our examples, this would actually reduce our normal projects below their 100,000 and increase marginal projects beyond their assumed numbers. In fact, we can be assured this does actually happen, *creating a net negative long-term impact upon our economy in terms of newly created viable projects from interest rate manipulations.*

In summary, the Fed surely knows all this, but is unwilling to admit their mistakes. They do not want to let the project failures currently "built in" to our economy happen, although in their heart of hearts, they know they will, eventually. Therefore, they intend to use any means necessary to keep interest rates as low as they can as long as they can in order to try to keep the dam from breaking on their watches. Bernanke's ZIRP legacy will be a bitter one, regardless of whether historians actually blame him for it or not.

Purpose

The CJ Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF's, ETF's, open-end mutual funds, and derivatives). Essentially, it reflects what I'm actually doing with my clients.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope

is that providing this information and teaching you what I consider important when investing may help you. I'd also love to hear any questions or comments you may have about my letter.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I analyze the markets and economy, as well as how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please contact me for more information.