CARLSON
FINANCIAL
MANAGEMENT

Interest Rate Blues

After nearly a decade of a near zero interest rate the Federal Reserve finally raised it, by one-quarter of one percent. The December 16, decision was preceded by several years of anguished expectation and broad ranged speculation. Every time the Fed's board of governors was set to meet, and they meet several times a year, market mavens put it out that stock prices were clearly being suppressed out of fear that a rate rise would seriously impede the economy. But the stock market never showed any clear pattern of reaction. The market index, the S&P 500, would experience a brief period of volatility then return to its ordinary course. Sometimes it would go up a bit and sometimes it would go down. The reason for this is that an interest rate rise, particularly a tiny one, will at this time have almost no real effect on the economy.

Historically this has not been the case. The Fed's interest rate manipulations had an enormous impact on business activity, on employment and inflation. When interest rates were low and the future looked promising it made sense to borrow and invest. The investment would boost production, more people would be hired and the return on invested capital would be much greater than the cost of the borrowed money. Similarly, when the economy was overheated an interest rate rise would increase the cost of capital and thus reduce the incentive to greater production. Indeed, Congress has given the Federal Reserve a specific mandate: maintain full employment and suppress inflation. Low interest rates are supposed to increase production and employment. High interest rates are meant to dampen inflation. Past a certain point a low interest rate, "cheap money", leads to inflation. It incentivizes too much borrowing, hence increasing the money supply at a rate greater than the increase in production. "Too many dollars chasing too few goods" is the old maxim.

But we do not now have either high unemployment or much inflation. We have neither an overheated economy nor a recession. So why did the Fed raise rates? The reasons they give are pretty weak. The first is that they want to get interest rates back to "normal". This assumes that average rates over say the last century define normal and that a well functioning economy both needs a "normal" interest rate and will

© 2016 Carlson Financial Management

naturally generate that rate. There is no evidence to support this idea. Historically there have been very long periods, even a century, in which average interest rates have been as low as they are today. The other reason given is that the Fed needs "tools" in order to accomplish its task. In other words it has to be able to manipulate interest rates to be able to influence the economy in the manner described above. The implication is that with interest rates near zero the Fed has nothing to work with. Again, this does not make sense. Clearly the Federal Reserve can raise rates any time it likes; it just did.

It can also lower rates, and here is where it gets interesting. The Fed can institute negative interest rates. This is an idea that John Maynard Keynes pioneered in the 1930s. The idea is that if a central bank actually charges other banks interest for the privilege of parking excess cash with it then those commercial banks will have an incentive to lend, hence stimulating the economy. If there is too much money around, the economy is sluggish and there are not enough obviously promising projects upon which to lend, then the stimulus of negative interest should motivate banks to take a little more risk. Until recently this was viewed as simply an interesting though quirky idea. It is also a bit counter intuitive. Who ever heard of paying for the privilege of lending someone else money? But under the pressure of a serious and enduring recession the

Between 2009 and October of 2014 the Fed created 3.5 trillion dollars of new money.

European Central Bank began to do just that. In July of 2014 it became the first major central bank to charge a negative rate. It began at -0.1% and it has now gone to -0.4%. The jury is still out as to the actual effect of this policy. The European economy was already beginning to improve, albeit very slowly, when negative rates were instituted. What we know for certain is that the policy has not created the hoped for boom. Europe is still mired in economic stagnation with very high unemployment and astronomical levels of youth unemployment.

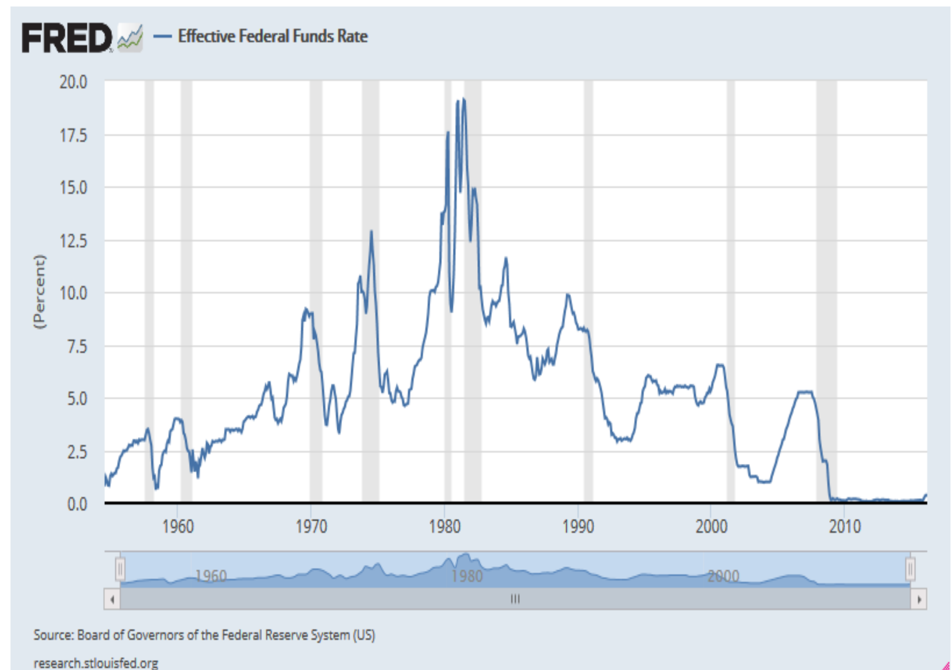
So why are interest rates so low? The answer is quite simple. The Federal Reserve has one other important instrument in its toolbox. In addition to being able to manipulate interest rates it can actually create money. This is a roundabout way of adjusting interest rates. The more money in the system, the more available money is, the lower the rates. Both tools ultimately are meant to make money cheap enough to encourage investment. Between 2009 and October of 2014 the Fed created 3.5 trillion dollars of new money. This expanded the money supply by more than one-third. We can argue about the impact of this policy. Some will say it avoided a depression and gave us the very mild but steady economic improvement that we have had for six years. What is clear, however, is that it is now irrelevant. Of that 3.5 trillion, 2.5 trillion ended up back on deposit with the Federal Reserve. In other words commercial banks have 2.5 trillion dollars that they are not willing to lend. There are not enough projects out there that they consider worthy of the risk, at any interest rate.

What can we do to reinvigorate the economy? Although official unemployment is low and some regions, like the Bay Area, are doing fine, few would say we are doing well. There is still huge underemployment, with people working part time when they would like to be fully employed and with many more considered outside the labor force only because there is nothing to bring them back in. Add to this the fact that living standards for the bulk of the population have not risen for decades.

Interest rates and money supply are important tools that can stimulate an economy but we

© 2016 Carlson Financial Management

have learned that there is an important qualifier that says: ‘but not always’. Ultimately the economy depends on psychology. When people feel optimistic they spend money and they invest, when they are pessimistic they hold on to their money. Banks are the same way. We hope that the very gradual improvement we have seen over the last many years will continue. At some point we should turn a corner, become genuinely optimistic and start the next boom.



Carlson Financial Management is a private wealth management firm dedicated to building and preserving wealth for individuals and families. We provide a unique combination of portfolio management services coupled with financial, retirement, tax and estate planning – all delivered with an underlying commitment to the highest quality personal service.

Investment Management Services

Our investment management services provide sophisticated portfolio management designed to build and preserve wealth for individual clients and their families. We employ a highly rigorous and disciplined approach to investment selection and portfolio management, using both fundamental and technical analysis in our evaluation of select market timing decisions.

Integrated Planning

At Carlson Financial Management we work with our clients to integrate their tax and financial plans with their long-term plans for retirement and distribution of estate-related assets. This comprehensive approach helps ensure that we create a multi-generational financial plan that will help our clients and their families realize their long-term financial goals and aspirations.

Client Service & Experience

Our commitment to clients is two-fold: we endeavor to provide the highest quality investment management coupled with the outstanding personalized attention and service only a boutique firm can provide. Our dedication to integrity, long-term relationships, and the highest standards of quality and performance is at the heart of everything we do.

1398 55th St. Emeryville, CA 94608 | 510-601-8800 | Fax 510-547-6258

© 2016 Carlson Financial Management