WINTHROP WEALTH

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CLIENT QUESTION
OF THE MONTH

THE FED

By Andrew Murphy, CFA | Co-Chief Investment Officer

Overview

The Federal Reserve, or simply the Fed, is the central bank of the United States. After the Financial Panic of 1907 and several bank failures, Congress decided that the country needed a central bank to act as the lender of last resort. As a result, the Fed was created by the Federal Reserve Act of 1913 and was signed into law by President Woodrow Wilson. The goal was to provide the nation with a safe, flexible, and stable monetary and financial system. The Fed is an independent government agency, but they are ultimately accountable to the public and Congress. While the President or members of Congress sometimes openly criticize the Fed, politics are not supposed to influence their decisions.

The Fed performs five key function to promote the effective operation of the US economy:

Conduct monetary policy for the United States	Help maintain the stability of the financial system	Supervise and regulate financial institutions	Foster payment and settlement system safety and efficiency	Promote consumer protection and community development

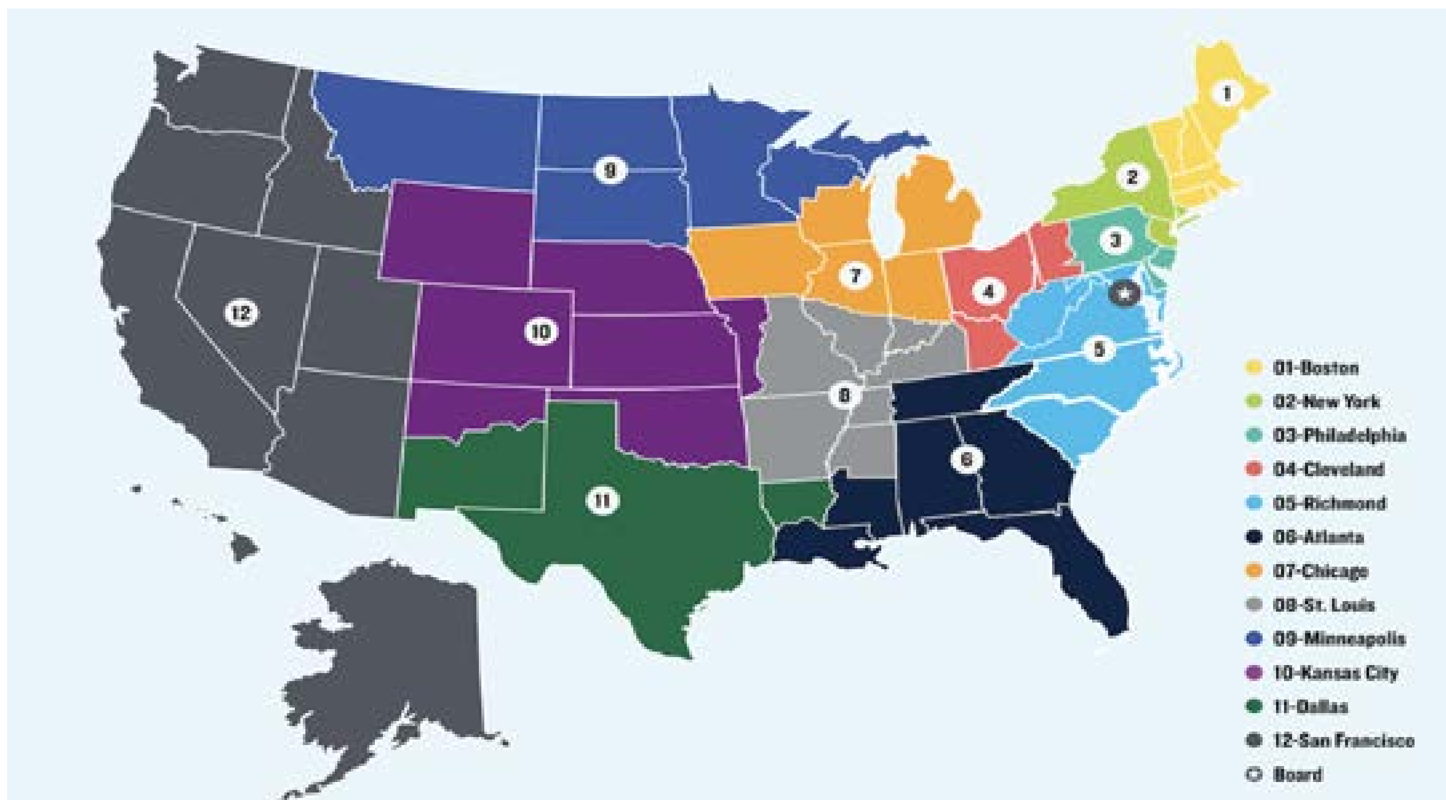
Key Entities

The three key entities of the Federal Reserve are the Board of Governors, the Federal Reserve Banks, and the Federal Open Market Committee (FOMC).

Federal Reserve Board of Governors
The board serves as the governing body for the Federal Reserve System. The Board of Governors are comprised of seven members who are each nominated by the President and confirmed by the Senate. Each member is appointed to a 14-year term, which are staggered so that one term expires on January 31st of every even number year. After serving a 14-year term, a board member cannot be reappointed.

The Fed Chair and Vice Chair are also appointed by the President and confirmed by the Senate. Both serve 4-year terms and may be reappointed. **Fed Chair**: Jerome Powell. **Fed Vice Chair**: Lael Brainard.

Federal Reserve Banks
The twelve Federal Reserve Banks act as the operating arm of the Federal Reserve System. Each of the twelve Reserve Banks operate within their own specific geographic region. The core functions of the Reserve Banks are to supervise financial institutions, offer lending services, and provide payment system functions to banks within their area. The Reserve Banks also collect data and information from their local communities and pass their findings to the FOMC as an input for monetary policy decisions.

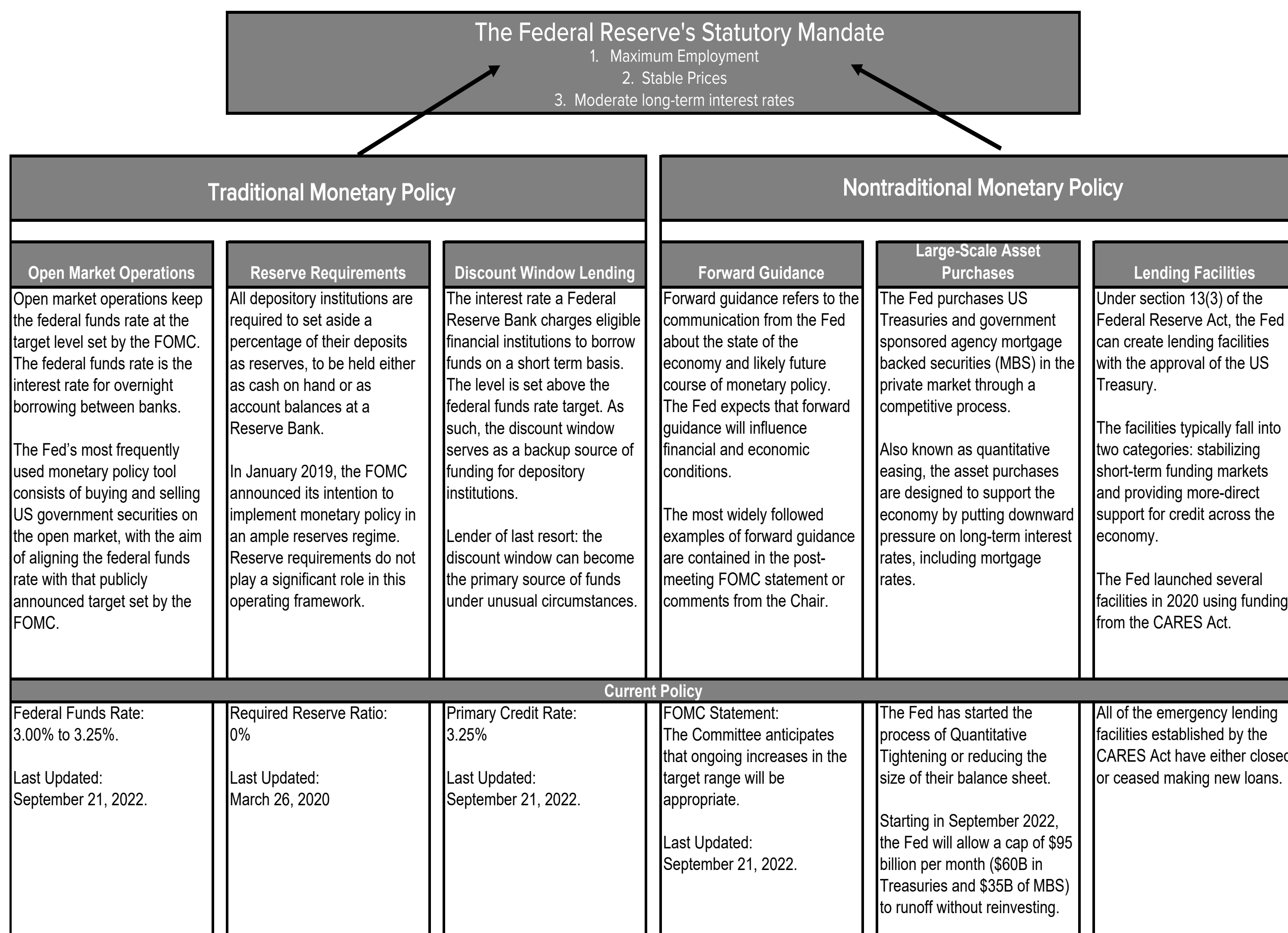


Federal Open Market Committee (FOMC)

The FOMC sets the national monetary policy on behalf of the Federal Reserve System. The FOMC is comprised of twelve voting members: the seven members of the Board of Governors, the President of the Federal Reserve Bank of New York, and four of the remaining eleven Reserve Bank presidents who serve one-year terms on a rotating basis. All twelve Federal Reserve Bank presidents attend FOMC meetings, but only voting members determine policy decisions.

The committee holds eight regularly scheduled meetings per year where the members review economic and financial conditions, assess risks to their economic outlook, and determine the appropriate stance of monetary policy.

The FOMC sets monetary policy through the use of traditional and nontraditional tools to achieve the three goals outlined by their statutory mandate from Congress.



FOMC Meetings

The FOMC considers three key questions at each of their meetings:

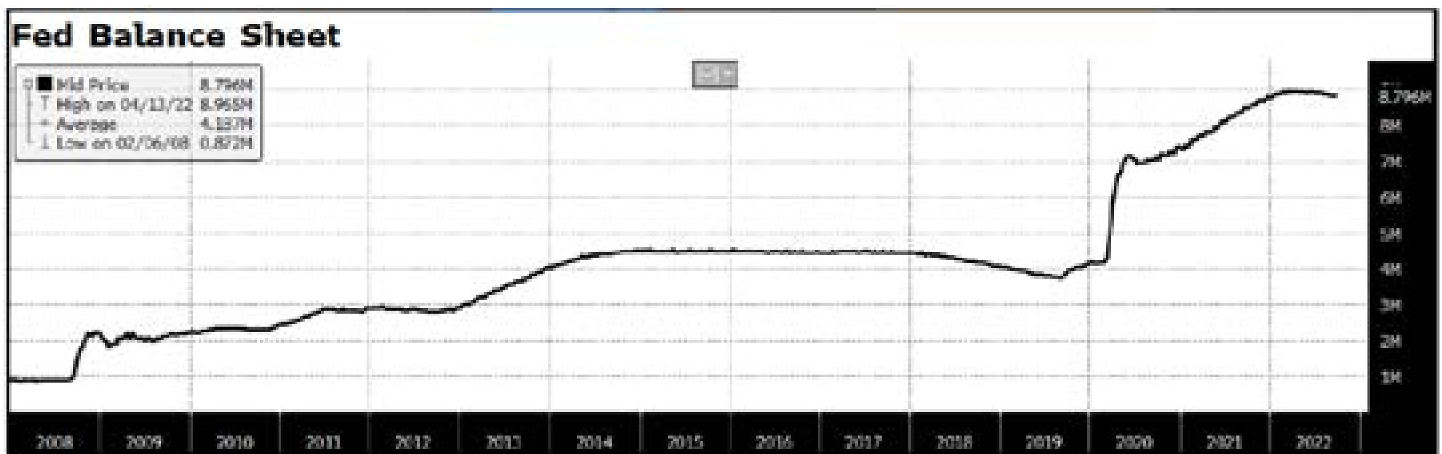
1. How is the US economy likely to evolve in the near and medium term?
2. What is the appropriate monetary policy setting to help the economy achieve the goal of 2% inflation and maximum employment over the medium term?
3. How can the FOMC effectively communicate its economic outlook and policy decisions?

The Fed's Balance Sheet

The Fed's balance sheet is the consolidated amount of assets and liabilities for all twelve Federal Reserve Banks. Assets include holdings of Treasuries and mortgage-backed securities (MBS), loans to other financial institutions, and the lending facilities. Liabilities include currency in circulation and bank reserves (deposits held at the Federal Reserve). Monetary policy has a direct impact on the size of its balance sheet. Generally, accommodative monetary policy will lead to a larger balance sheet while restrictive monetary policy will lead to a smaller balance sheet.

Prior to the financial crisis, the Fed's balance sheet did not receive much attention from the investment community. However, once the Fed launched their quantitative easing programs to help the economy recover from the crisis, the balance sheet began to receive a lot more focus. The Fed's quantitative easing programs also helped to monetize a lot of the debt issued by the Treasury for fiscal stimulus programs (please see our **Client Question of the Month on the federal debt**). Here is a brief history of the Fed's recent quantitative earning and tightening programs:

2008 – 2015: the Fed launched three separate quantitative easing programs and increased the balance sheet from about $900 billion to over $4.5 trillion.
2015 – 2019: quantitative tightening brought the overall size down to less than $4 trillion.
2020 – 2022: during the start of the covid pandemic, the Fed launched an open-ended quantitative easing program along with several lending facilities, increasing the balance sheet to nearly $9 trillion.
2022: the Fed started quantitative tightening designed to shrink the balance sheet by up to $95 billion each month.



Controlling the Monetary Base – Printing Money

The Fed has direct control over the monetary base, which is the sum of currency in circulation plus bank reserves. When the Fed wants to inject liquidity into the economy, they can increase the monetary base by printing money, either physically or digitally. Physically printed money is distributed through the Federal Reserve banks. Digitally printed money occurs when the Fed buys bonds and credits bank reserves. For example, assume the Fed buys a Treasury bond from a bank. The Fed will take ownership of the bond and credit the bank's reserve account for the corresponding amount.

Bank reserves are cash held in the vault or deposits at regional Federal Reserve banks. The Fed started to pay interest on reserves on October 1, 2008. The current interest rate on reserve balances (IORB rate) is 3.15% as of 9/21/22. Banks can choose to earn interest on their reserves held at the Fed or to lend the funds out into the economy.

How Monetary Policy Impacts the Economy, Interest Rates, and Stock Prices

"My job continues to be to predict the financial markets, particularly the major stock, bond, commodity, and foreign exchange markets around the world. To do this job well, I've learned that nothing is more important than to anticipate the actions of the Federal Reserve System's Federal Open Market Committee (FOMC), which sets the course of monetary policy in the United States."
- Ed Yardeni, Market Strategist

The FOMC sets monetary policy to establish the financial conditions they believe will best achieve their three mandated goals of maximum employment, stable prices, and moderate long-term interest rates. As conditions in the economy change, the FOMC will adjust monetary policy accordingly. The Fed's most commonly used monetary policy tool is adjusting the federal funds rate. Accommodative monetary policy occurs when the FOMC is trying to boost the economy, while restrictive monetary policy occurs when the Fed is trying to slow the economy (typically because inflation is running higher than preferred).

According to the Fed, monetary policy directly affects interest rates; it indirectly affects stock prices, wealth, and currency exchange rates. Through these channels, monetary policy influences spending, investment, production, employment, and inflation in the United States. Effective monetary policy complements fiscal policy to support economic growth.

Economy

The Fed states that monetary policy affects the US economy primarily thought its influence on the availability and cost of money and credit. The Fed's decisions will impact a wide range of spending decisions by individuals and corporations. When the Fed shifts to accommodative monetary policy and lowers the federal funds rate, lower interest rates will stimulate greater spending on durable goods. Since consumer spending drives about 70% of GDP, a decrease in interest rates that elicits increased spending will boost the economy.

The Fed also points out that higher stock prices will also lead to increased spending due to the wealth effect. When stock prices increase, shareholders' overall wealth increases. Intuitively, when individuals feel wealthier, they spend more money.

Interest Rates

Short-Term

The FOMC generally controls short term interest rates by setting the federal funds rate. As the federal funds rate increases or decreases, US Treasury bills, commercial paper, and other short-term bonds typically follow.

Long-Term

Normally, the FOMC has an indirect impact on long-term interest rates. Usually, the market controls long-term rates as investor demand varies based on future expectations of inflation and economic growth. However, if the FOMC wants a more direct impact on long-term interest rates, they will conduct quantitative easing to purchase bonds in the open market.

Stock Prices

"The most direct and immediate effects of monetary policy actions, such as changes in the federal funds rate, are on the financial markets."
- Ben Bernanke, Former Fed Chair (2006 – 2014)

Monetary policy has a significant impact on interest rates and thereby equity prices. Accommodative monetary policy historically has lead to lower interest rates and higher stock prices while restrictive monetary policy has had the opposite effect.

When you buy a share of stock, you are purchasing an ownership stake in the underlying company. Your ownership stake represents a claim on the firm's cash flows, earnings (profits), and dividends. *Stock investing includes risks, including fluctuating prices and loss of principal.*

Stock prices reflect the present value of the company's expected future earnings. Interest rates effect both the present value calculation and the expected amount of future earnings of a stock by impacting the discount rate, the relative value tradeoff against other asset classes, and the amount at which the company can borrow or refinance. Note that these influences are not mutually exclusive, they happen simultaneously but at different levels depending on company specific factors.

Interest rates impact stock prices by changing:

1. The discount rate used to calculate the present value of future cash flows.
2. The relative value tradeoff between stocks and other asset classes (i.e. bonds or cash).
3. The amount at which corporations can borrow or refinance.

Interest Rates ↓		**Interest Rates ↑**	
Lower Discount Rate	As the discount rate decreases, the present value of future cash flows becomes more valuable.	Higher Discount Rate	As the discount rate increases, the present value of future cash flows becomes less valuable.
Relative Value of Stocks Increase	As interest rates decrease, so do the expected returns of fixed income investments. Stocks become more attractive as individuals or institutional investors who require a return above a certain threshold are forced to buy riskier assets to achieve those targets.	Relative Value of Stocks Decrease	As interest rates increase, so do the expected returns of fixed income investments. Stocks become less attractive as individuals or institutional investors who require a return above a certain threshold can purchase "safer" investments to achieve those targets.
Corporate Cash Flows Increase	Corporations can take advantage of lower interest rates by adding leverage or refinancing existing debt, thereby increasing cash flows.	Corporate Cash Flows Decrease	As interest rates increase, corporations will hesitate to issue new debt due to higher interest expenses and/or they will pay more on any floating instruments, thereby decreasing cash flows.
Stock Prices ↑		**Stock Prices ↓**	

Conclusion

"Don't fight the Fed."
- Martin Zweig, Market Strategist

The Fed and their monetary policy decisions have a significant impact on the economy and financial markets. Since the Financial Crisis, the Fed has grown even more impactful as they have become more willing to use nontraditional monetary policy tools to boost the economy.

During the pandemic, the Fed launched the most accommodative monetary policy environment in United States history. From March 23, 2020, through December 31, 2021, the S&P 500 increased by nearly +120% with very little volatility. As inflation started to increase in early 2021, the Fed insisted that it was transitory and did not require any adjustments to the still ultra-accommodative monetary policy. The Fed began to change their thinking in late 2021 before slamming on the brakes of the economy by significantly tightening throughout 2022. The Fed's pivot to ultra-restrictive monetary policy this year has been jarring for financial markets. Only 21 months ago, the Fed was projecting that inflation would end 2022 under 2% and they would not raise rates until 2024. Now the Fed is projecting that inflation will not fall to 2% until after 2025 while interest rates will hit 4.6% in 2023.

The Fed typically focuses on balancing maximum employment and stable prices, however, today the committee is hyper focused on bringing inflation down even if it means causing a recession. Fed Chair Powell recently admitted that higher interest rates will lead to a "sustained period of below-trend growth that will also bring some pain to households and businesses." This is the Fed Chair's way of telling the American people to buckle up.

With hindsight it's clear that the Fed was wrong in their view that inflation was transitory, and the committee waited too long to tighten monetary policy. We will refrain from being overly critical of the Fed (and leave that to pundits) and focus on what matters most, which is analyzing what current and future monetary policy decisions mean for the markets, economy, and ultimately our clients. The Fed admits that monetary policy operates on a long and variable lag. Our sense is that the Fed is likely to overengineer by raising interest rates too high before quickly reversing course and cutting them in the face of a weakening economy. While the Fed is ready for "pain", they likely won't sit on their hands or continue to tighten in an undebatable recession. In other words, we expect the actual path of monetary policy to look a lot different than what the Fed is currently estimating.

At Winthrop Wealth, monetary policy is a vital component to our market outlook and portfolio positioning. We continue to believe that analyzing the impact of current Fed policy and anticipating the potential implications of future policy are critical to sound portfolio management.

We apply a Total Net Worth Approach to both comprehensive financial planning and investment management. We believe financial planning drives the investment strategy and provides a roadmap to each client's unique goals and objectives. The comprehensive financial plan defines cash flow needs, is stress tested for various market environments, seeks to optimize account structures, considers tax mitigation strategies, and continuously helps to evaluate financial risks as circumstances and/or goals change. The investment management process is designed to provide well-diversified portfolios constructed with a methodology based on prudent risk management, asset allocation, and security selection. *Investors should be aware that no strategy assures success or protects against loss. Investing has risks including loss of principal.*

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Financial planning is a tool intended to review your current financial situation, investment objectives and goals, and suggest potential planning ideas and concepts that may be of benefit. There is no guarantee that financial planning will help you reach your goals.

Rebalancing a portfolio may cause you to incur tax liabilities and/or transaction costs and does not assure a profit or protect against a loss.

Asset allocation does not ensure a profit or protect against loss. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio.

Diversification does not protect against market risk. All investing involves risk which you should be prepared to bear.
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