SEPTEMBER 2023 CLIENT QUESTION OF THE MONTH

THE FED

By Andrew Murphy | Co-Chief Investment Officer

WINTHROP WEALTH

<u>Overview</u>
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 are sometimes openly critical, politics are not supposed to influence Fed decisions.

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

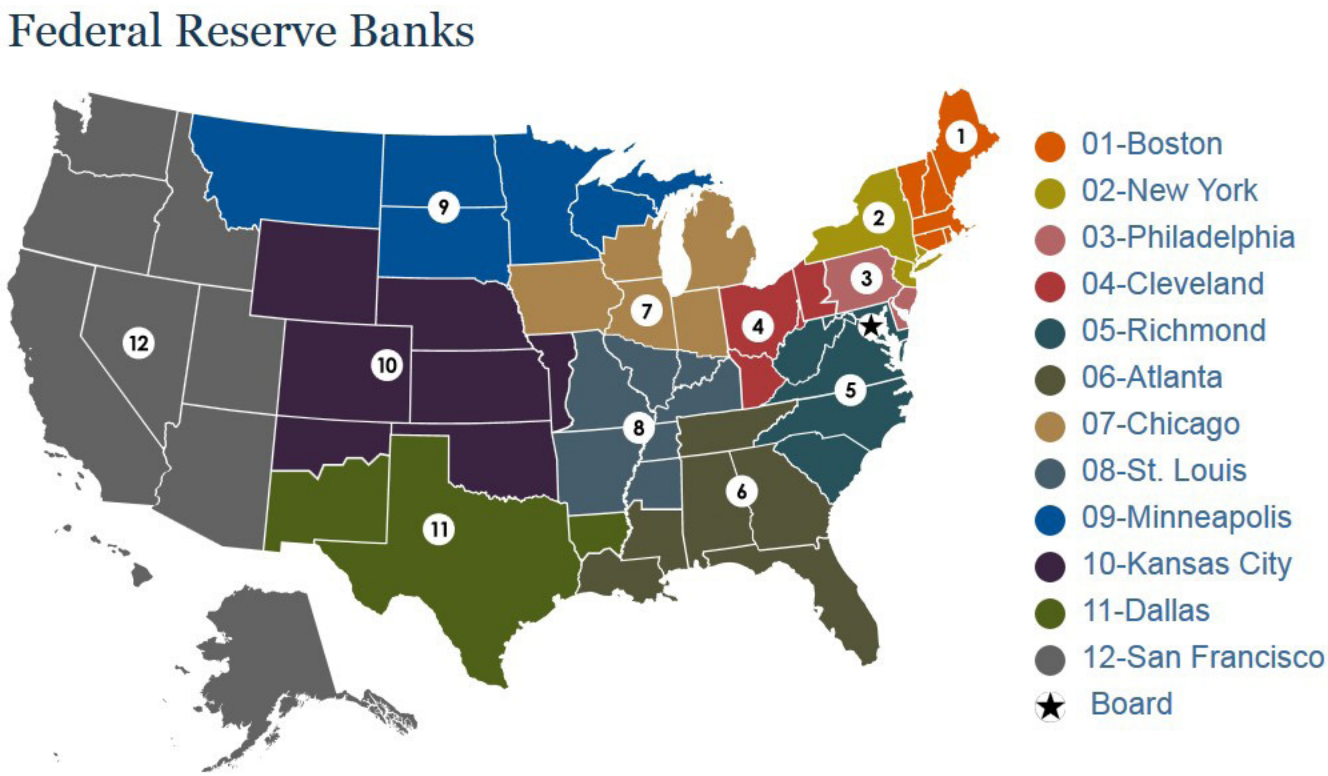
Functions	Help maintain the stability of the financial system	Supervise and regulate financial institutions	Foster payment and settlement system safety and efficiency	Promote consumer protection and community development

<u>Key Entities</u>
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: Philip Jefferson (nominated).

Federal Reserve Banks
The twelve Federal Reserve Banks act as the operating arm of the Federal Reserve System. Each of the twelve Reserve Banks works within their own specific geographic region. The core functions of the Reserve Banks are to supervise financial institutions, offer lending services, examine certain financial institutions, 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 input for monetary policy decisions. Each Reserve Bank effectively acts as a "bank for banks" for their district.



Federal Open Market Committee (FOMC)

The FOMC sets the national monetary policy on behalf of the Federal Reserve System. Monetary policy is defined as the FOMC actions undertaken to promote maximum employment and price stability. When fully staffed, 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.

The Federal Reserve's Statutory Mandate

1. Maximum Employment
2. Stable Prices

Traditional Monetary Policy			Nontraditional Monetary Policy		
Open Market Operations	**Reserve Requirements**	**Discount Window Lending**	**Forward Guidance**	**Large-Scale Asset Purchases**	**Lending Facilities**
Open market operations keep the federal funds rate at the target level set by the FOMC. The federal funds rate is the interest rate for overnight borrowing between banks. The Fed's most frequently used monetary policy tool consists of buying and selling US government securities on the open market, with the aim of aligning the federal funds rate with that publicly announced target set by the FOMC.	All depository institutions are required to set aside a percentage of their deposits as reserves, to be held either as cash on hand or as account balances at a Reserve Bank. In January 2019, the FOMC announced its intention to implement monetary policy in an ample reserves regime. Reserve requirements do not play a significant role in this operating framework.	The interest rate a Federal Reserve Bank charges eligible financial institutions to borrow funds on a short term basis. The level is set above the federal funds rate target. As such, the discount window serves as a backup source of funding for depository institutions. Lender of last resort: the discount window can become the primary source of funds under unusual circumstances.	Forward guidance refers to the communication from the Fed about the state of the economy and likely future course of monetary policy. The Fed expects that forward guidance will influence financial and economic conditions. The most widely followed examples of forward guidance are contained in the post-meeting FOMC statement or comments from the Chair.	The Fed purchases US Treasuries and government sponsored agency mortgage backed securities (MBS) in the private market through a competitive process. Also known as quantitative easing, the asset purchases are designed to support the economy by putting downward pressure on long-term interest rates, including mortgage rates.	Under section 13(3) of the Federal Reserve Act, the Fed can create lending facilities with the approval of the US Treasury. The facilities typically fall into two categories: stabilizing short-term funding markets and providing more direct support for credit across the economy. The Fed launched several facilities in 2020 using funding from the CARES Act.
Current Policy					
Federal Funds Rate: 5.25% to 5.50%. Last Updated: July 26, 2023.	Required Reserve Ratio: 0% Last Updated: March 26, 2020	Primary Credit Rate: 5.50% Last Updated: July 26, 2023.	FOMC Statement: In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. Last Updated: July 26, 2023.	Quantitative Tightening or reducing the size of the balance sheet is ongoing. Starting in September 2022, the Fed is allowing the balance sheet to decrease by a maximum of $95 billion ($60B in Treasuries and $35B of MBS) each month.	In response to the banking sector turmoil in March 2023, the Fed established the Bank Term Funding Program (BTFP) that offers loans to banks pledging collateral. The program was designed to help assure that banks have the ability to meet the needs of all their depositors.

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?

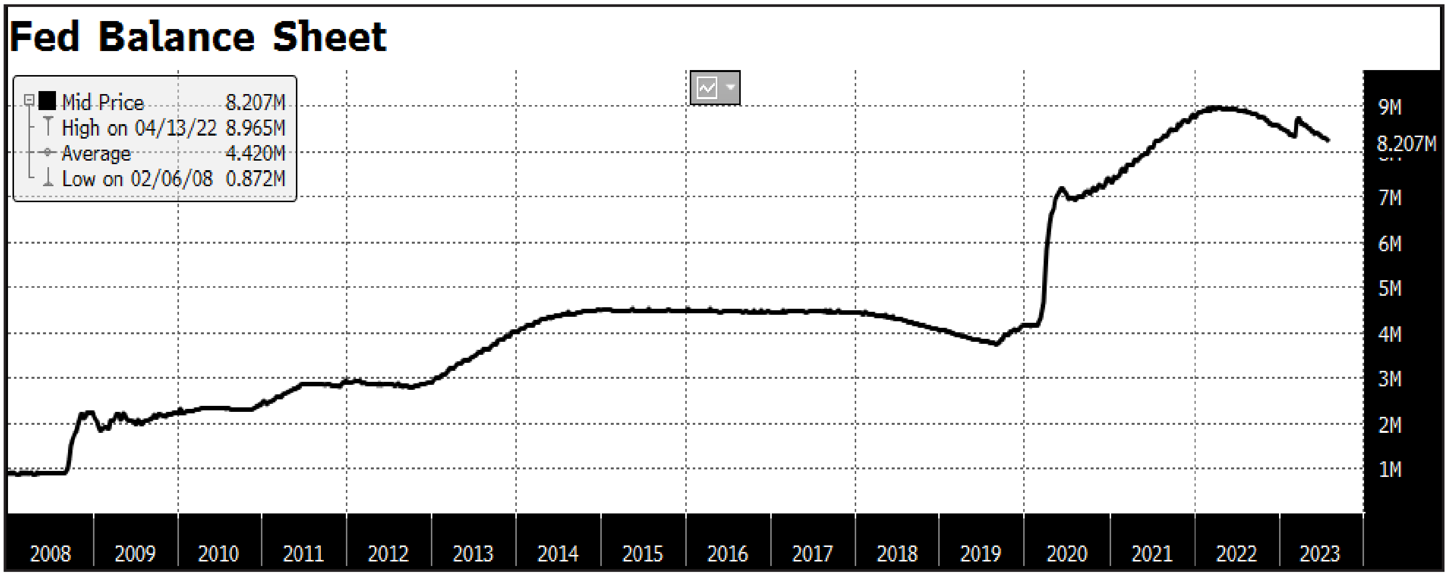
The Fed's Balance Sheet

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 their 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 the 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:

Time Period	Quantitative Easing/Tightening FOMC Actions
2008 - 2015	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 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 -	Quantitative tightening designed to shrink the balance sheet by up to $95 billion each month.

Source: Federal Reserve



Source: Bloomberg

<u>Controlling the Monetary Base – Printing Money</u>

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 5.40% as of 7/26/23. Banks can choose to earn interest on their excess 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 mandated goals of maximum employment and stable prices. 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 goods and services. 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 influences 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 bond rates 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/tightening to purchase or sell 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 generally leads to lower interest rates and higher stock prices while restrictive monetary policy has 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 ↓	
Lower Discount Rate	As the discount rate decreases, the present value of future cash flows becomes more 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.
Corporate Cash Flows Increase	Corporations can take advantage of lower interest rates by adding leverage or refinancing existing debt, thereby increasing cash flows.
Stock Prices ↑	

Interest Rates ↑	
Higher Discount Rate	As the discount rate increases, the present value of future cash flows becomes less valuable.
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 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 ↓	

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 by lowering the federal funds rate to zero, starting an open-ended quantitative easing program, and launching several new lending facilities designed to increase the flow of credit to households and businesses. Due to the massive amounts of fiscal and monetary stimulus, inflation started to rapidly increase throughout 2021. By 2022, the Fed no longer viewed the inflation spike as “transitory”, and they began to slam on the brakes of the economy by aggressively tightening monetary policy. From March 2022 through July 2023 the FOMC raised the federal funds rate by over 500 basis points (bps) to 5.00% to 5.25%. After one of the quickest tightening cycles in US history, the federal funds rate is at its highest level in 22 years.

Today, inflation has decelerated from peak levels but remains above the Fed’s target, while the economy is performing better than most have expected. The Fed remains committed to bringing Core PCE Inflation, currently at +4.1% Y/Y, back down to their 2% target. At the latest FOMC meeting, Fed Chair Powell stated that, “inflation remains well above our longer-run goal and the process of getting back down to 2% has a long way to go.” According to their latest Summary of Economic Projections, the Fed is forecasting one more 25 basis point rate hike during this cycle. While we believe that inflation will continue to fall without the need for further rate increases, the Fed appears determined not to let a reacceleration occur. We expect the Fed will continue to talk tough and threaten more hikes until either disinflation becomes painfully obvious, or the economy begins to stumble. As the past several years have demonstrated, Fed policy changes very quickly.

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 successful portfolio management.

We apply a Total Net Worth Approach to wealth management that combines both comprehensive financial planning and investment management. The financial plan helps define cash flow needs, seeks to optimize account structures, considers tax mitigation strategies, and determines the appropriate asset allocation based on the client’s willingness and ability to take risk. Based on the output of the financial plan, our investment management process designs a well-diversified portfolio constructed with a long-term methodology based on prudent risk management, asset allocation, and security selection. No strategy assures success or protects against loss. Investing involves risk, including loss of principle.

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The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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Past performance is no guarantee of future results.

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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