<u>THE FED'S GAME: CHEATING THE SAVERS</u>
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Hank Williams sings in "Your Cheatin' Heart" that "Your cheatin' heart will tell on you".

DRAMATIC MOVES…TRUST THE DEALER?

Surely the wonderful Federal Reserve Board should be beloved by all Americans, for it undoubtedly has our economic interests at heart! United States stock marketplace bulls (just look at the S+P 500 at over 1850 now compared with March 2009's bottom around 667) and corporations adore the Federal Reserve's long-running easy money game. Debtors generally love the Fed's policies too. Shouldn't everyone be enamored of sustained interest rate yield repression joined to an effort to create allegedly sufficient inflation? Why question the Fed's interpretations of its responsibilities? Why dare quarrel with its actions?

Since end December 2008, the Federal Reserve's highly accommodative monetary strategy has pinned the Federal Funds rate to the zero to .25 percent floor. In the Fed's ardent fight to spark and promote economic growth, reduce unemployment, achieve its opinion of what constitutes "stable prices" (inflation of two percent), it has engaged in a massive money printing scheme. Not to be outdone, the European Central Bank, Bank of England, and the Bank of Japan, as well as China's central bank, also have engaged in assorted lax monetary methods.

Ravenously purchasing US debt securities via its quantitative easing festivals, the Fed now holds outright about $3.95 trillion (yes, trillion; see the Fed's H.4.1), up around one trillion dollars from mid-March 2013. Its current debt securities hoard equals about 23.5 percent of US calendar 2013 GDP of $16.8 trillion. In its eager hands, the Fed grasps $2.30tr in US Treasury notes and bonds and $1.60tr mortgage-backed securities. How big are these holdings relative to five years ago, after the end of the glorious Goldilocks Era and during the dreadful days of the global economic disaster? The central bank's debt securities have ballooned nearly eight-fold relative to year end 2008's comparatively small $500 billion.

PLAYING GAMES

Desperate measures such as a rock-bottom Fed Funds level and gigantic money printing helped to boost financial confidence, protect the international banking system, and raise values for assets such as US stocks and homes. In the context of the darkest times of the fearful American (and global) economic calamity, with its lofty unemployment and few signs of significant recovery on the horizon, brutal suppression of the Fed Funds rate for an extended period seemed sensible. But for more than five years? Moreover, the Fed remains determined to keep repressing interest rates in its quest to achieve and sustain two percent inflation.

But isn't over three trillion dollars of money printing a little much? Current low inflation does not necessarily preclude high inflation later. And although in its recent meetings the Fed elected to taper modestly its debt buying, this coach's 3/19/14 policy pronouncement maintains its allegiance to generous quantitative easing for several more months. The Fed thereby will add many more billions in debt securities to its portfolio. This program "should maintain downward pressure on longer-term interest rates". And it promises to keep the Fed Funds at its current depth for a "considerable time" after its securities buying binge ends. Marketplace players conjecture that asset purchases may cease around end 2014. If so, yield repression policies probably will not change anytime soon.

Though the Fed woos audiences with pillow talk regarding its diligent monitoring of the economic scene, the Fed nevertheless has not unveiled a detailed coherent exit strategy for its extremely accommodative policies.

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The Federal Reserve Board enjoys widespread popularity. Most of Wall Street, Main Street, and political circles are fans. In general, financial media cheerleaders bolster the Fed's reputation. The great respect presently enjoyed by the Fed encourages faith that its creative policies are not at anyone's expense (at least in any very substantial way). The Fed's monetary game undoubtedly is good for one and all, especially over a misty long run vista, right?

Yet let's not move so fast. Many debtors like inflation, for it reduces the burden of their outstanding obligations. America is a major debtor nation.

Total US credit marketplace debt at end 2013 was a towering $59.0 trillion, roughly double 2001's $29.4tr. Scan the post World War II period in regard to the debt to GDP relationship. The bottom in overall US credit marketplace debt as a percent of nominal GDP was 1951's 129.4pc. After gradually rising for about 30 years, it then started racing uphill from 1981's 163.7pc. In 2003, it attained 301.8pc. During the marvelous Goldilocks Era, it leaped up to 353.1pc in 2007. As the American and global financial crisis erupted and proceeded, total US credit marketplace debt peaked at 371.0pc in 2009. The total US debt percentage at end 2013, 351.2pc, has fallen only modestly fall since 2009. Household debt, though somewhat down from its peak, remains very substantial as a percentage of GDP. Besides, Federal debt has grown in recent years. See "America the Debtor" (3/17/14).

A review of the Federal Reserve's policies since end 2008 (and arguably those for several months before this) in the context of this massive American debt problem shows that the Fed for quite some time has significantly favored debtors (borrowers) at the expense of creditors (savers).

FED MANDATES AND INTEREST RATES

The Fed team endlessly has proclaimed its unstinting devotion to what it calls its "dual mandate" of maximum employment and stable prices. Yet Federal Reserve Act Section 2A, buried in the Fed's website, says the Fed should promote effectively three goals, not just maximum employment and stable prices, but also "moderate long-term interest rates". There really is a triple mandate. On the rate topic, what defines moderate and long term is unclear. Are the debt instruments involved only US Treasuries, or also corporate and municipal securities and mortgage lending rates?

Anyway, the Fed for several years has seldom bothered to focus on the language and substance of this moderate long term rate mandate requirement. Why not? Probably because the Fed seeks to avoid close scrutiny of the cheat the saver (help the debtor and borrower) strategy it married itself to during the worldwide economic crisis.

Given that Fed references to this third mandate regarding rates are rare, spectators should underline the clever interpretation of the Fed's statutory directive by the revered former Fed Chairman, Ben S. Bernanke. In his speech, "A Century of U.S. Central Banking: Goals, Frameworks, Accountability" (7/10/13), this icon preaches: "the interest rate goal…can be regarded as subsumed within the dual mandate" since "the long-term interest rate goal is viewed as likely to emerge from the macroeconomic environment associated with the achievement of the employment and price stability goals". Likely to emerge? Maybe so, maybe not.

Yet if moderate long term rates supposedly will "emerge" from an "environment associated with the achievement" of the other two goals, those moderate long term interest rates therefore probably will not appear prior to that environment/achievement. The Fed does not believe it has achieved its so-called dual mandate; see its 3/19/14 announcement. Consequently, currently repressed United States long term yields probably do not meet the "moderate" standard. Moreover, those long rates probably have not achieved the moderate benchmark for several years. The Fed's intertwined and sustained securities buying (money printing) and Fed Funds policies, as well as its forward guidance serenades, further indicate this general failure to reach moderate (adequate) interest rate levels.

What follows from this falling beneath the moderate long run rate standard? Keep in mind that the Fed deliberately has repressed rates along the entire government yield curve (and thereby rates to some extent in other yield domains) by means of its Fed Funds rate maneuvers and its money printing extravaganza. Therefore for several years the Fed has cheated savers across the entire yield curve (from a few months out to 30 years) in order to help (and even rescue some) debtors. Experts can debate regarding as to the money these savers have sacrificed. But the total is not small. Undoubtedly the Fed has faith that what it has done, is doing, and will do, is good for "all of us" (or almost all of us) over the long run.

Since the Fed does not overtly mention the moderate long rate mandate in its policy statements, and as Bernanke's speech buries his explanation of that interest rate goal in a footnote (number 20), the Fed dealer probably wants marketplace players to avoid thinking too much about how the Fed has fixed the interest rate game, favoring debtors (borrowers) at the expense of savers (creditors). And they probably (and especially) do not want interest rate marketplace savers (creditors) to shout about how they have received insufficient return relative to signpost inflation measures such as the consumer price index or personal consumption expenditures.

CHEATING SAVERS

In general, don't savers ("investors") in the US Treasury securities arena deserve a moderate real return relative to inflation?

America's consumer price index inflation rate (CPI-U, all items) declined .4 percent in calendar 2009, rising 1.6pc in 2010, 3.2pc in 2011, 2.1pc in 2012, and 1.5pc in 2013. The five year average increase thus was 1.6 percent. The CPI-U for February 2014 ascended 1.1pc over the last 12 months; it climbed 1.6pc in January 2014 (before seasonal adjustment; Bureau of Labor Statistics, 3/18/14)

Since December 2008, the Federal Funds rate has been less than .25 percent (monthly average, with February 2014's merely .07pc; Fed H.15 statistics). Given the Fed's highly accommodative policy management from December 2008 to the present, survey the US government yield curve in the context of the average CPI increase of 1.6pc for the calendar years 2009 through 2013.

The average US two year Treasury note yield (the average of monthly averages; H.15) from December 2008 through February 2014 is .54 percent. Since June 2011, the monthly average has stayed consistently beneath half of one pc. Over the roughly five year span from December 2008 through February 2014, the average five year UST note yield was 1.52pc. Thus there has been a negative real return for the two and five year UST notes relative to the 1.6 percent average consumer price inflation of the 2009-2013 period. This negative real return of course has been true for maturities less than two years as well. Though these Treasury bills and notes have had stretches within the 2009-2013 history (as in 2009) with positive returns relative to inflation, this does not change their overall picture of negative real returns.

The Fed's statutory mandate does not mention an aim for moderate short or medium term interest rates. Does that implicitly give the Fed license to particularly cheat the short and medium interest rate marketplace savers (investors) to serve other statutory goals? Is it appropriate to take advantage of those short and medium run savers and shortchange them for a long run (or any other fairly lengthy) period?

The average yield on the UST 10 year note from December 2008 to February 2014 is about 2.68 percent, only about one percent above 2009-2013's average 1.6pc CPI. The interest rate for the 30 year bond has averaged about 3.71pc. The 30 year yield perhaps may seem satisfactory, unless one underlines that Fed Open Market Committee (FOMC) participants on balance believe that the "longer run" target of the Fed Funds rate is around four percent.

What about yields nowadays? On 3/21/14, the US three month Treasury bill yield was merely .05 percent, with the two year Treasury note only .42pc. The five year note's 1.71pc yield barely edged above the 2009-13 inflation average. The 10 year UST yield was 2.74pc, the 30 year's 3.61pc.

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