



INVESTMENT UPDATE

We've been saying for months that a twenty-five basis point hike in the Fed funds rate is no big deal. That the bond market of the past few decades had shrugged off Fed funds hikes like a dog shaking off after a refreshing dip in the river. The Fed has used the funds rate to make fine-tune adjustments to US monetary policy since the 70s; it should be routine. After all, in 2004–06 the Fed pushed up the funds rate 17 times in less than 24 months. What possible difference would it make, we argued, whether the funds rate was 0.00% or 0.25%, where it stands today, after the first rate hike in almost a decade?

Could we have been mistaken, thinking that things in 2016 are the same as they were

twenty years ago, or even ten years ago? Certainly, the years since the end of the financial crisis have seen ground-shaking changes in global economics, not the least of which have been extraordinary measures taken by central banks all around the world to keep their banking systems functioning and their national and regional economies growing.

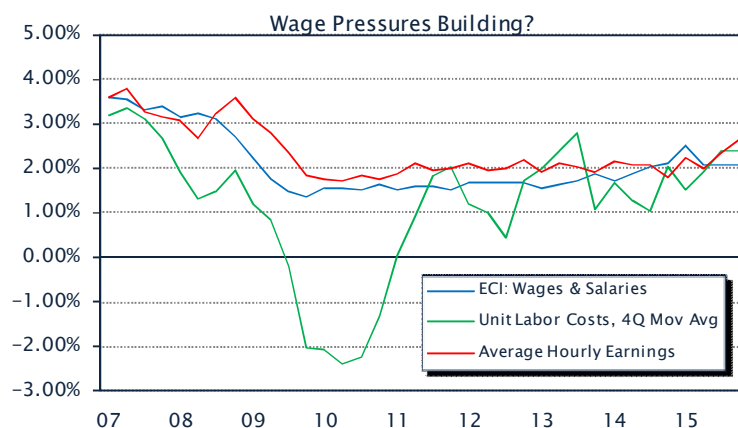
One needs to look no further than the Fed's balance sheet—which has ballooned from less than \$1 trillion to more than \$4.5 trillion since 2008—to see evidence of how the landscape has changed. There have been similar massive injections of liquidity from the Fed's central bank counterparts, most notably the Bank of Japan and the European Central Bank (ECB), which have poured trillions more into their economies. The People's Bank of China, along with a host of other Chinese agencies, have been on high alert for nearly a year, trying to engineer a soft landing while their economy deals with a global slowdown, partly of their own making.

But all that liquidity hasn't had the expected outcome. Yes, in the US, we have seen the economy grow, but at a pace well below its potential; we haven't had real annual GDP growth of 2.5% or more since the financial crisis. Results overseas have been even more disappointing, with Japan continuing to flirt with

deflation and Europe still looking at little to no growth and unemployment rates in important economies like Italy and France still above 10%.

Of course, unemployment in the US is now 4.9%, below what the Fed considers NAIRU—the "non-accelerating inflation rate of unemployment"—the level at which labor shortages begin placing upward pressure on wages. This, along with continued net payroll increases of 200,000 per month, provides the Fed "cover" for pushing up the Fed funds rate while the rest of the world's central banks still have the monetary pedal to the metal. Clearly, Fed officials want to normalize the funds rate,

to get it up towards 1% with another two or three rate hikes in 2016, so that the Fed funds rate can be lowered at some point in the future, as needed, to stimulate the US economy when the inevitable slow-down comes. As it stands now, the Fed cannot use their most basic, traditional tool to relax monetary policy; additional quantitative easing (AKA, further expansion of their balance sheet) looks like the Fed's only weapon to stimulate the US economy at this point.



Yes, there are growing signs that wage pressures are building (see chart), which is not surprising given the strength in the US labor markets over the past few years. But there is far more obvious evidence that pushing up short term rates may not be the right course of action right now. Getting back to the original question of this *Update*—it seems that a 25 basis point hike in the funds rate is a very big deal indeed.

The chart on the back page shows just how low yields on short-maturity government bonds are right now—among our major trading partners, many are now below zero, a state of affairs we would have thought impossible only a few short years ago. Clearly, this is not the same environment that we've known, and the Fed's determination to "right size" monetary policy

based on old models seems wildly out of place.

Since the December rate hike, the global capital markets have been having their say about the Fed's overnight rates policy, and it's not pretty. In January alone, more than \$8 trillion of wealth evaporated around the world as stock markets plummeted—that kind of wealth destruction has a significant impact on consumer confidence and spending decisions. The average junk bond is trading at a yield north of 10%, higher than at any point since the financial crisis ended, a de-facto indicator of tightening lending standards. China is scrambling to keep its economy growing, and desperate moves are the order of the day; the ECB in December lowered the overnight lending rate to -0.30%, while the Riksbank, Sweden's central bank, reduced its official overnight rate to -0.50% earlier this month, and the Bank of Japan followed suit.

It's one thing for certain "government-only" bond buyers (along with panicked investors fleeing risky assets) to drive bond prices up to the point where rates turn negative, but it's another matter entirely for a central bank to establish a policy that

charges commercial banks 30 to 50 basis points of interest on overnight funds. Bank stocks, especially in Europe, have tumbled as their profits are sure to come under severe pressure under these conditions. Deutsche Bank, the giant German

institution whose stock price has fallen by more than 30% so far in 2016, along with other European banking giants, are still cleaning up their balance sheets from the aftermath of the financial crisis, almost a decade after the US banks took their hits. Negative overnight rates, which are supposed to encourage loan generation by punishing banks for sitting on cash, are instead squeezing their profits at exactly the wrong time. And since banks cannot pass these negative rates on to their customers (depositors can simply withdraw the funds and hold cash), negative overnight rates by central banks are just as likely to inhibit growth as encourage it.

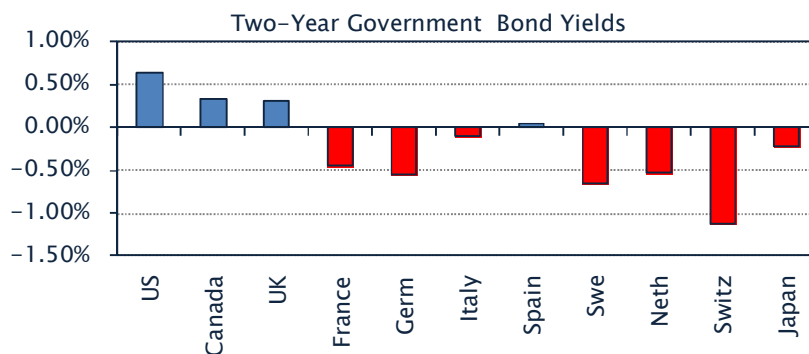
Could that happen here? For her part, Fed Chair Janet Yellen has refused to rule out the possibility that the US might some day institute a negative Fed funds rate policy; in her testimony to Congress this month, she said only that the Fed will continue

studying whether it "would be workable here." Fortunately, other Fed officials have been more forthright, with NY Fed President Bill Dudley saying that it is "an extraordinarily premature conversation to be having," considering the relative strength in the US economy and given the fact that policy is still "appropriately quite accommodative" even after a 25 basis point rate hike. We certainly agree with Mr. Dudley, and would hope that the negative overnight rates being used by some central banks do not become a policy option for the Fed.

It seems clear to us that the world's central banks can only do so much, and that eventually each country's economic well-being will depend on the types of policies—both fiscal and monetary—each has in place to encourage investment and economic growth, without unusual assistance from the central bank. It's hard to tell a central banker that, though, particularly when they believe that their job is to "fix" things when the economy isn't growing at its potential.

What we're seeing, after nearly a decade of "extraordinary" measures, is that the world's central banks have bumped up

against the harsh reality that their powers become less and less effective with each turn of the screw. Yes, the Bernanke-led Fed stabilized the US and global banking system, and Mario Draghi's ECB's promise to do "whatever it takes" to keep the



European Monetary Union together must be considered successful. But now that their balance sheets have been bloated with the bonds they bought and took out of circulation, and the dollars, yen, Euros, et al., have been printed and put into circulation, what comes next?

Credibility is the real currency that modern economies deal in, and that credibility must be backed up by policies, institutions and people that are sensible and instill confidence. In a world with excess capacity of most every factor of production, including currency, it's now time for central bankers to show some discipline, and draw the line on new programs designed to spur production.

We've got enough product, what we need is a little more discipline, and credibility and confidence will follow.