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WEALTH MANAGEMENT

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Monthly Insight

The Fed, the Economy, and the Financial Markets

Especially during times when the economy is in flux—such as in early 2020, when the coronavirus pandemic was causing economic shutdowns, not only in the US, but across the globe; or as now, when inflation driven by an accelerating economy is threatening to get out of control—we typically read a lot in the financial news about the US Federal Reserve (“the Fed”) and what it is doing—or should be doing—to keep the economy afloat and on track. Often, even remarks made by the Fed chair, Jerome Powell, or by one of the regional governors of the Federal Reserve Board, are enough to send ripples through the financial markets, as investors and analysts interpret these remarks as indications about future decisions the Fed might make.

For example, Powell recently suggested that the Fed might decide to raise benchmark interest rates by 50 basis points—one-half of one percent—at its May meeting. The bond market reacted with a drop in prices, since the prospect of higher interest rates in the future makes current bonds less valuable (when bond prices fall, bond yields go up). Also, because the Fed historically has tended to raise rates in 25-basis-point increments, Powell's comments were interpreted as confirmation that the Fed will attempt to be "tough" on inflation. Finally, the Fed chair also mentioned that the central bank will begin selling some of the huge inventory of Treasury securities it accumulated during its "easing" period, when it was buying billions in those same securities in order to maintain liquidity in the economy during the pandemic-induced recession.

All of these stories outline or mention ways that the US Federal Reserve and the central banks of other nations try to exert influence on the national and international economy to promote greater economic stability. And each of these actions—and the way they are perceived by investors, analysts, and business leaders—can have an effect on the economy which, in turn, affects the financial markets. Let's take a closer look at three of the Fed's principal tools—control of interest rates, control of the money supply, and control of public perception of its policies—and how they can nudge the economy and affect the investments in your portfolio.

1. Interest rates. This is perhaps the best-known device the Fed uses and it is also the one that has the most direct effect on investors. The Federal Reserve sets the interest rate on certain types of transactions involving funds held in reserve at one of the twelve regional Federal Reserve Banks. Because banks in the United States must maintain certain liquidity requirements, they often borrow from and loan money to each other through overnight reverse repurchases, interbank loans, and other short-term transactions. Banks also sometimes maintain reserve balances of funds held in Federal Reserve Banks. By controlling the rate of interest paid on these balances, the Fed essentially sets the base rate of interest for most interest-bearing instruments in the economy. Sometimes referred to collectively as the "Fed funds rate," this benchmark interest rate essentially signals the Fed's current and future intentions for interest rates.

In the current inflationary environment, the Fed is nudging interest rates higher in an attempt to make it more expensive for companies to borrow. By raising the effective "price of money," higher interest rates can help to slow the pace of economic growth, which is one of the principal engines that drives higher inflation.

But it's a delicate balancing act. If rates rise too high too fast, that can choke off economic growth, rather than merely slowing it, and the Fed doesn't want to do that. So, the central bank uses an incremental approach, its goal being to find the "sweet spot" for interest rates that will rein in runaway inflation without asphyxiating the economic recovery.

2. Money supply. The definition of inflation is "too much money chasing too few goods and services." To address this imbalance, the Fed and other central banks will also use their ability to increase or decrease the amount of money in circulation. They typically do this through what are called "open-market operations," which means the Fed buys or sells financial instruments. When the Fed is buying, they are putting money into circulation. They did this on a massive basis during the Great Recession of 2007–09 and again during the COVID recession of 2020, because their policy was dedicated to maintaining liquidity in the economy, essentially providing fuel for the sputtering economic engine so that it wouldn't stall out completely.

Now, however, with the economy revving up again, the Fed is trying to prevent the opposite effect—to keep the economy from overheating and pushing inflation to dangerous new heights. So, the Fed has announced that it will begin selling off a larger portion of its portfolio of US Treasury securities and other holdings, thus pulling money out of circulation in an attempt to create a better balance between the money supply and goods and services in the economy.

3. Public announcement of policy. Both of the above discussions explain the outlines of actions the Fed takes in order to keep the economy growing at a healthy rate: not too fast, and not too slow. But now let's look at a different type of influence the Fed tries exert: its announced intentions for monetary policy. Sometimes, simply by saying what the Fed plans to do or what they think it should do, the Fed chair and other leaders of the central bank can influence the direction of the financial markets. This gets into an area where psychology and expectations come into play, as analysts, investors, and others try to judge the likely effectiveness of Fed policy in light of current economic conditions.

This matters, because when inflation is in the news, as it has been for most of this year so far, economists and other analysts—including those who work at large Wall Street firms—start to worry that rising prices will become a self-fulfilling prophecy. After all, it's no secret that we're all paying more for things like groceries, gasoline, rent, and even printer paper. Supply-chain pressures aren't helping; we've all read the stories of container ships sitting offshore, waiting to unload, and trucks with no drivers to take their loads to the companies awaiting delivery. In return, small businesses—your barber, the place where you get your oil changed, and even your favorite restaurant—feel forced to raise their prices in response to the higher cost of goods. At some point, it looks like "everybody's doing it," and the inflationary cycle starts to run at least partly on public perception. When that happens, it can be harder to bring inflation under control.

All of this is why the Fed's current "tough talk" posture toward inflation is an important signal. It is intended to convince investors, analysts, and economists that the US central bank has its eye on the ball and is prepared to do what is necessary to keep inflation in check. This perception is actually a tool of the Fed, in that it can help to alleviate concerns and reduce the likelihood of the “self-fulfilling prophecy” discussed above.

At Empyrion Wealth Management, we are dedicated to one core principle: Our clients’ best interests come first. That means that whether the economic environment is inflationary or deflationary, whether the markets are up or down, the focus of our research and guidance is on helping our clients make the smart financial decisions that allow them to achieve their most important goals. To learn more, click here to read our recent article, “Current Inflation Is Easy to Explain ... Or Is It?

Stay Diversified, Stay YOUR Course!

SOCIAL MEDIA DIGEST

In case you missed them, here is a roundup of my latest posts on social media:

With yields at historic lows, the news for fixed-income investors has not been encouraging for a while. But interest rates don't tell the whole story.

Think about your future: What does life look like for you and your family?

EWM Digital Planning allows you to try out a range of life scenarios, see the real-time impact of your choices, and assess risk.

Money is a useful tool for married couples but it can also serve as a root cause for arguments. In my latest Fox40 news appearance, I explain some common money mistakes that couples make and share some tips for avoiding them.

Many seniors are looking for ways to augment their incomes in ways that also contribute to quality of life. Here we look at turning your passion into a paycheck.

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