The Fed Crossed The Line

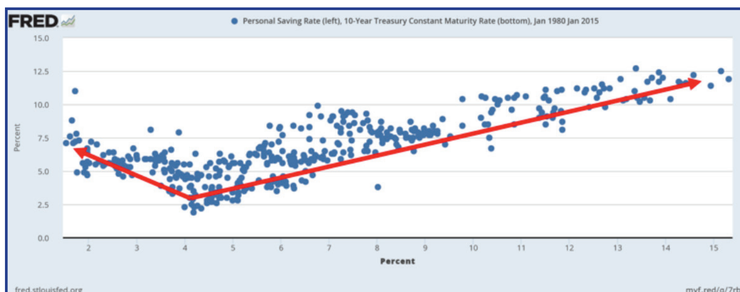
SYNOPSIS

- The Fed's decision to drastically cut interest rates prevented the financial crisis from deepening, but it has remained in place for far too long.
- Low interest rates do encourage consumers to spend more money, but there is a point where the drawbacks outweigh the benefits to the economy.
- The absolute best outcome for our economy is a return to a more normal interest rate environment, and the Fed is only holding us back by keeping rates at current levels.

TIME TO CHANGE

The Federal Reserve Bank (Fed) has maintained a policy of artificially low rates since the depths of the financial crisis, and the extreme measures they took prevented our country from falling into a depression.

That being said, this monetary policy has overstayed its welcome and currently represents more of an economic headwind than the tailwind it provided in years past. The chart below explains why in greater detail.



This chart plots the 10-year Treasury yield on the horizontal axis and the personal savings rate for U.S. consumers on the vertical axis for each month since January 1980. I drew two red lines to approximate a "v-shaped" trend, which represents the crux of my argument.

***NOTE**: The 10-year Treasury yield is considered to be a "benchmark" interest rate since it is used as a basis for so many loans, such as mortgage rates.*

The longer red line indicates that a higher benchmark rate corresponds to a higher savings rate. This relationship makes sense because higher interest rates will make loans more expensive for houses, cars, and other big ticket items.

If consumers are not spending their money because interest payments make goods unaffordable, then they are saving it, which increases the personal savings rate. On the flip side, lower interest rates on goods should incentivize consumers to spend more and save less.

However, there is a line in the sand where this relationship changes. The shorter red line indicates that once benchmark rates fall from around the 4% level, the savings rate reverses course and actually *rises*.

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This pattern is much less intuitive because one would assume that even lower interest rates would encourage consumers to take out even more loans, but the opposite appears to be the case. I believe that there are two main reasons for this behavioral shift.

1. **No Income:** Super low interest rates also generate super low returns on ultra-safe investments. Those households who rely on income from government bonds and bank CDs, particularly retirees, cannot spend money because they are not earning money.

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2. **Bad Signal:** Super low rates have only been used during extreme situations like the Great Depression. Keeping rates this low is inadvertently signaling that the economy remains perilous, and a worried consumer tends to spend less and save more.

Combine these two headwinds, and the Fed has created an environment where no matter how attractive loans become, consumers cannot or will not spend money. This is a problem for an economy that is predominantly driven by consumer spending.

Simply put, lower benchmark interest rates do encourage consumers to spend more and save less, but only until the point where the pain from earning nothing on ultra-safe investments exceeds the benefit from cheap loans.

IMPLICATIONS FOR INVESTORS

The Fed employs some of the brightest economic minds in the world, and Chairwoman Yellen is a highly accomplished economist who likely understands unemployment better than anyone else alive. There is no question that these people are experts at analyzing data and observing trends.

I do not claim to be such an economist, but I do try to be a realist, and even though I cannot provide any statistically significant evidence to support my theory above, I have learned through experience that not all economic theory taught in textbooks accurately reflects human behavior.

In this case, trying to model the fear of running out of money during retirement into consumer spending trends would most likely yield an outcome that is too imprecise for most economists. However, to me, there is no reason to even try because the observation alone is more than enough evidence to conclude that ultra-low interest rates need to go.

Being a realist, I also recognize that my views on interest rates will never get incorporated into our monetary policy. Even if the Fed were to read my writings, they would likely counter with their standard defense that they are doing no harm since inflation remains below their target range (clearly nobody at the Fed has to pay rent, buy groceries, or cover medical bills that seemingly double every four years).

Therefore, my goal is not to advocate the Fed to move but rather explain to investors why they should not fear the day when rates begin to rise. All that will be happening is a move back to the point on that curve where consumers can spend more and save less, which will make our economy even stronger.

The bottom line is that the Fed has kept their extreme policy measures on for way too long, and the best possible outcome for our economy would be to return to a more normal interest rate environment in an orderly fashion.

Sincerely,

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