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VIEWS FROM CAMELBACK MOUNTAIN
Central Banks' Foolishness

Central banks around the world have been conducting a giant science experiment with ultra-low and now with some negative interest rates in the hope of stimulating economic growth. The experiment began almost 15 years ago when Alan Greenspan and the Fed dropped U.S. interest rates to very low levels to combat the economic effects of the September 11, 2001 attack on the U.S. Initially, this was a correct and appropriate action. Unfortunately, the Fed became infatuated with the perceived benefits of ultra-low rates and left rates too low for too long. The result was to ignite an unsustainable housing boom fueled by nearly "free" loans. Financial institutions jumped on the bandwagon and invented new, dangerous funding vehicles in an attempt to get higher yields than those that were available in the marketplace. This contributed to the 2008/2009 financial crisis and the great recession.

In September 2008, Ben Bernanke and company were at it again and they lowered rates to zero and subsequently further eased monetary policy with their experimental Quantitative Easing (QE). First was QE1, then QE2 and so on. Soon the Fed's balance sheet rose from 0.9 trillion dollars to a high of over 4.5 trillion dollars (yes, a fivefold increase). All of these unorthodox monetary experiments produced and continue to produce meager economic growth, at best. Proponents argued that the policy was sound because the economy would have been in even worse condition without it. Pro-government, Keynesian economists argued that even though the U.S. national debt has doubled to 19 trillion dollars in the last eight years, even more fiscal stimulus should have been applied.

A more reasonable assessment might be that this monetary policy experiment just hasn't worked. The basic theory is that lower rates make loans cheaper, which will stimulate demand for houses, cars, and other big ticket items that most consumers borrow to purchase. While this is certainly true, early on after interest rate cuts, there were many other negative repercussions of low rates. First and foremost, savers are disadvantaged and driven to higher risk investments to get even modest yields. It also wreaks havoc with the banking system and misallocates capital throughout the economy. There are many byproducts and unanticipated consequences of an extended period of low interest rates.

Fast forward to 2015/2016, the U.S. economy is growing at 2% (plus or minus). The Fed is in a quandary over their unsuccessful experiment with zero rates. They know they have to gradually raise rates, but they are concerned that if they raise rates too quickly, this will disrupt financial markets and throw the U.S. economy into a recession. They implemented a small increase in December 2015 and monitored repercussions. Markets have been volatile, but overall directionless. They are now looking for excuses to continue down their desired path; to do nothing and keep interest rates to near zero for a very long time.

Meanwhile, in Europe and Japan, central banks have one upped the Fed's zero rate policies with negative interest rates. Swiss interest rates are now negative for their 30 year bonds. This experiment contends that by pushing rates to negative levels, borrowing costs will be further lowered. Once again, this monetary stimulus doesn't work and their answer is to lower rates even further. As bad as zero rates are for banks, negative rates are even worse. Europe is literally destroying its already dangerously weak

banks and this is grinding their lending and commerce to a halt. Whatever minimal benefits derive from negative rates, they are more than offset by the disruption to their banking system. Some European banks will soon need new government bailouts to fix this monetary policy driven crisis.

Brexit, the unexpected vote by Great Britain to leave the European Union (EU) is fueling new opportunities for more central bank foolishness which is to lower rates further. The British pound has declined and pulled the euro down some. Uncertainty about the British withdrawal has markets concerned.

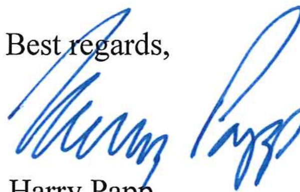
After a sharp two day drop, U.S. financial markets in the subsequent four days recovered most of the decline in anticipation of the Fed not raising rates at all in 2016 or 2017. Some are expecting the Fed to reverse their December 2015 rate increase to bring rates back down to zero. The preferred reason for 0% rates is to halt the increase in the value of the U.S. dollar.

The basic laws of economics do not change much. Relationships and the impacts can be delayed or accelerated, but basic economics will win in the end. Eventually, inflation will pick up; perhaps first in wage rates and then the Fed will have to act. Rates will eventually move higher towards normal equilibrium levels and the Fed will be forced to behave rationally. If inflation picks up, the bond market will become concerned that the Fed is "out of touch", "behind the times" or "not in control" and they will have to react in response to the changes that will occur in the bond market. Bond market conditions can change rapidly if confidence in the Fed is damaged.

Financial markets have priced in at zero or near zero percent rates for a long time. If this proves incorrect, it will lead to significant changes in the value of many investments whose current values are predicated on zero or near zero rates over a long time. We are carefully avoiding these holdings for our clients.

The U.S. economy, for all of its problems, is large and diverse. We are the envy of the world in terms of transparency and liquidity. Every time there is a global crisis money flows to safety, which is the U.S. dollar and Unites States Treasury obligations. Even though we expect significant changes in the bond market, our economy is much better positioned to deal with the impact of these changes than are other markets around the world. Our banking system is now safe and secure and our banks are well capitalized. We do anticipate that these changes will bring volatility. Our markets will be fine overall, but investors need to be careful to avoid problem sectors and companies that might become vulnerable as conditions change.

Best regards,



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