FED UP WITH FED TALK? CENTRAL BANKS AND INTEREST RATES – FAIRY TALES AND FACTS

The Fed did it!

The Fed acts (finally)…

- The big story on Wednesday, September 18, was that the Federal Reserve's open market committee finally got around to "cutting rates", and doing so by more than expected.
- This action, much debated and discussed during all of 2024, was greeted as big news, and market prognosticators argued that it was a harbinger of big market moves, both in interest rates and stock prices.
- The market seemed to initially be disappointed in the action, dropping after the Fed's announcement on Wednesday, but it did climb on Thursday.
- As a long-time skeptic about the Fed's (or any Central Bank's) capacity to alter much more than talk, I decided now would be as good a time as any to confront some widely held beliefs about central banking powers, and counter them with data.

Myths about the Fed (from most fantastic to least)…

- **The Fed as rate setter**: In this myth, the Fed (or central banks) set the interest rates that we encounter as consumers and businesses in our day-to-day affairs.
- **The Fed as rate leader**: In this one, the Fed may not directly set rates, but its actions determine the future course of interest rates.
- **The Fed as signalman**: The Fed, with its superior access to data, sends signals to markets, which then determines their next moves.
- **The Fed as stock market whisperer**: The Fed, in this myth, whispers to stock markets (with its actions), and they behave accordingly.

1. The Fed as Rate Setter

- As I drove to the grocery story on Fed Cut Wednesday, I had the radio on, and in the news at the top of the hour, I was told that the Fed had just cut interest rates, implying that consumers would soon see lower rates on their mortgages and businesses on their loan.
- That delusion is not restricted to newscasters, since it seems to be widely held among politicians, economists and even market watchers.
- The truth, though, is that **the Fed sets only one interest rate, the Fed Funds rate**, and that **none of the rates that we face** in our lives, either as consumers (on mortgages, credit cards or fixed deposits) or businesses (business loans and bonds), face interest rates that **are set by or even indexed to the Fed Funds Rate**.

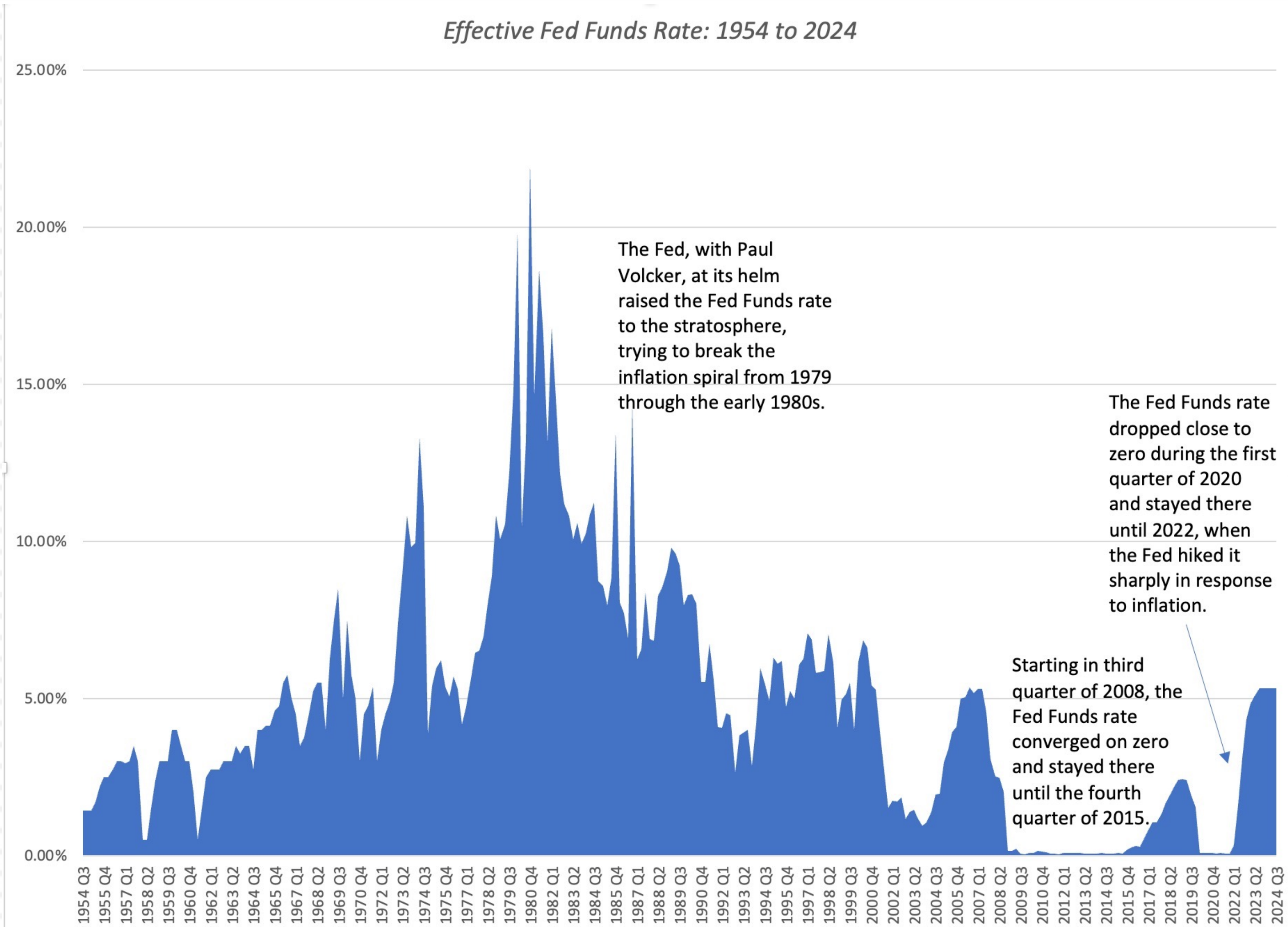
The Fed Funds Rate

- The place to start to dispel the "Fed sets rates" myth is with an understanding of the Fed Funds rate, an **overnight intra-bank borrowing rate** is one that most of us will never ever encounter in our lives.
- The Federal Open Market Committee (FOMC) has the power to change this rate, which it uses at intervals, in response to economic, market and political developments.
  - In most cases, the rate changes come at one of the eight regularly scheduled FOMC meetings.
  - In a few cases, the rate changes come after emergency meetings, usually in response to a crisis (2001, 2008, 2020)

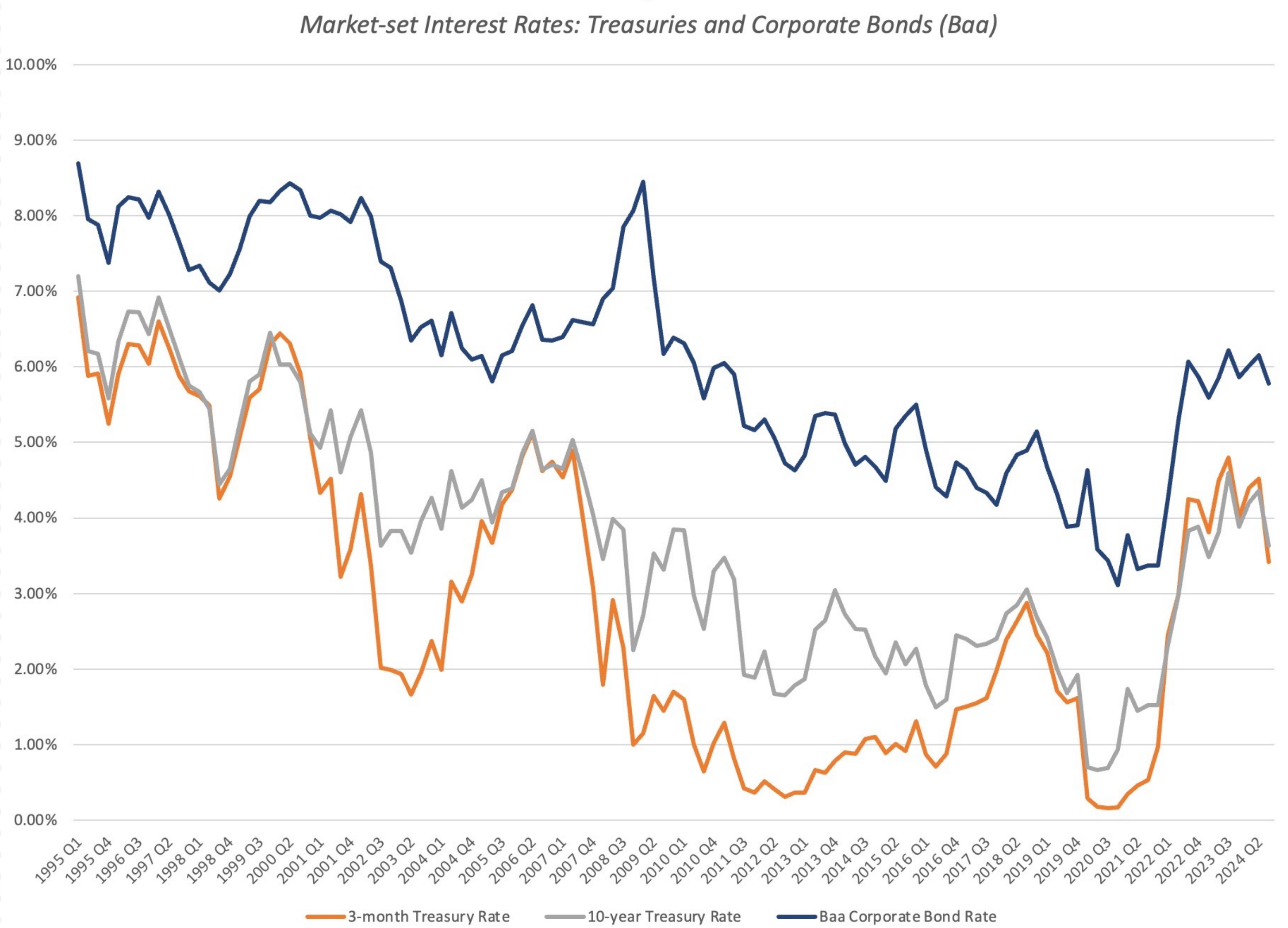
A History of Fed Action (and Inaction)

Period	Fed Action
1981-1990	The Volcker-led Fed focused attention on the money supply, rather than the Fed Funds rate, leading to a long period of inactivity on that front.
1991 - 2000	Under Alan Greenspan, the Fed become more activist, at least on the Fed Funds Rate front. There were thirty three rate changes during the decade, with nineteen decreases and 14 increases. Twenty five of the rate changes were 0.25%, seven were 0.50% and there was one of 0.75% (and increase in November 1994).
2001-Sept 2008	With Greenspan in charge through 2006, and Ben Bernanke continuing, there were thirty seven rate changes between 2001 and Sept 2008, with twenty two being cuts and fifteen representing increases. Of these changes, twenty two were 0.25%, thirteen were 0.50% and two were 0.75%.
Sept 2008 - 2021	With Bernanke in charge until 2014, Janet Yellen from 2014 to 2018 and Jeromer Powell after 2018, there were seventeen rate changes, with the first three in the last quarter of 2008, dropping the rate close to zero percent. There were nine increases between 2015 and 2018, three decreases in 2019 and two more decreases in 2020, with the last one being a 1% decrease, reducing the Fed Funds rate towards zero percent.
2022 -2023	Under Jerome Powell, there were eleven rate increases during the period, five of 0.25%, two of 0.50% and four of 0.75%.
Sep-24	The Fed Funds rate was cut by 0.50%.

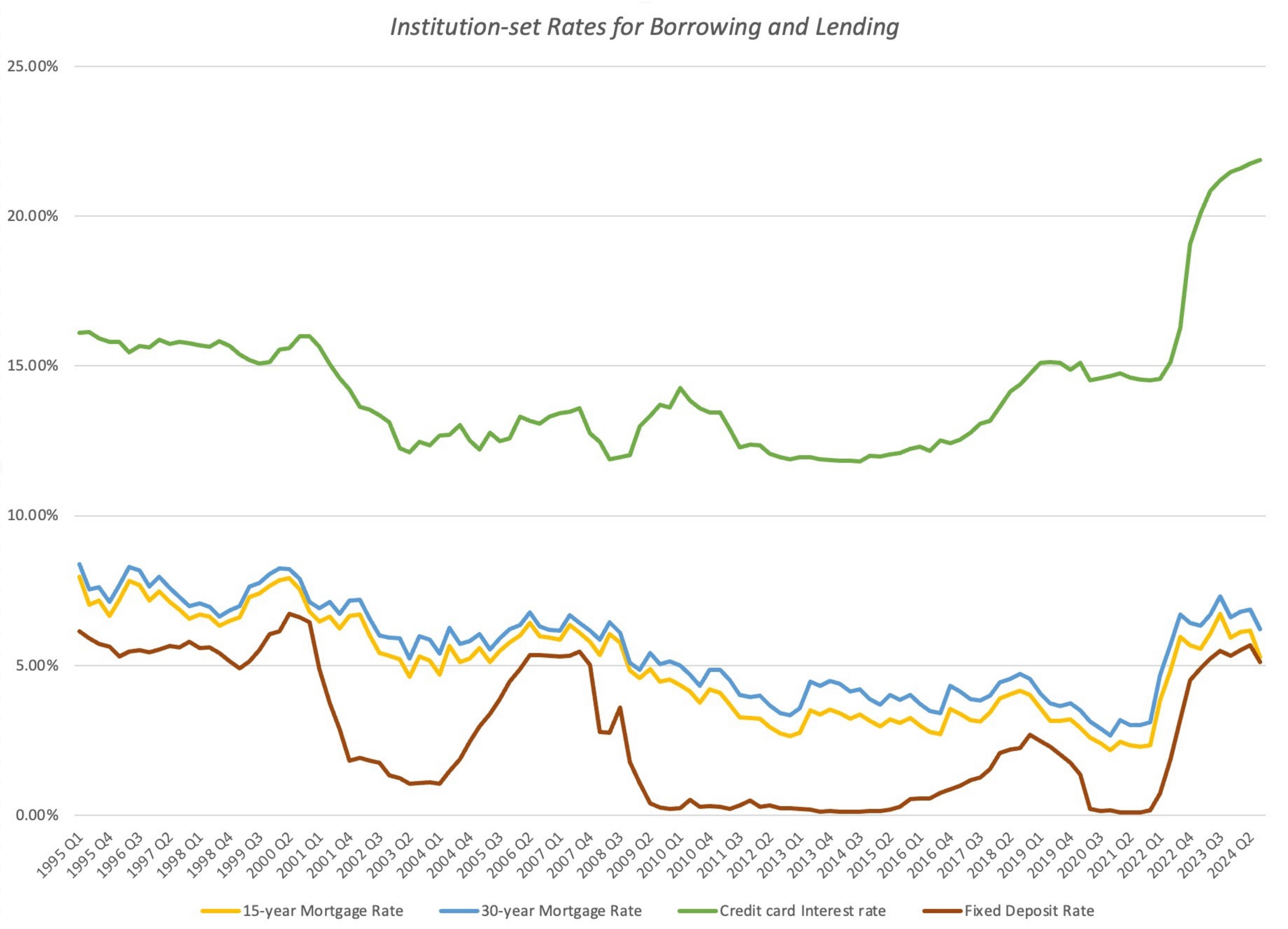
The Effective Fed Funds Rate



Market-set Rates



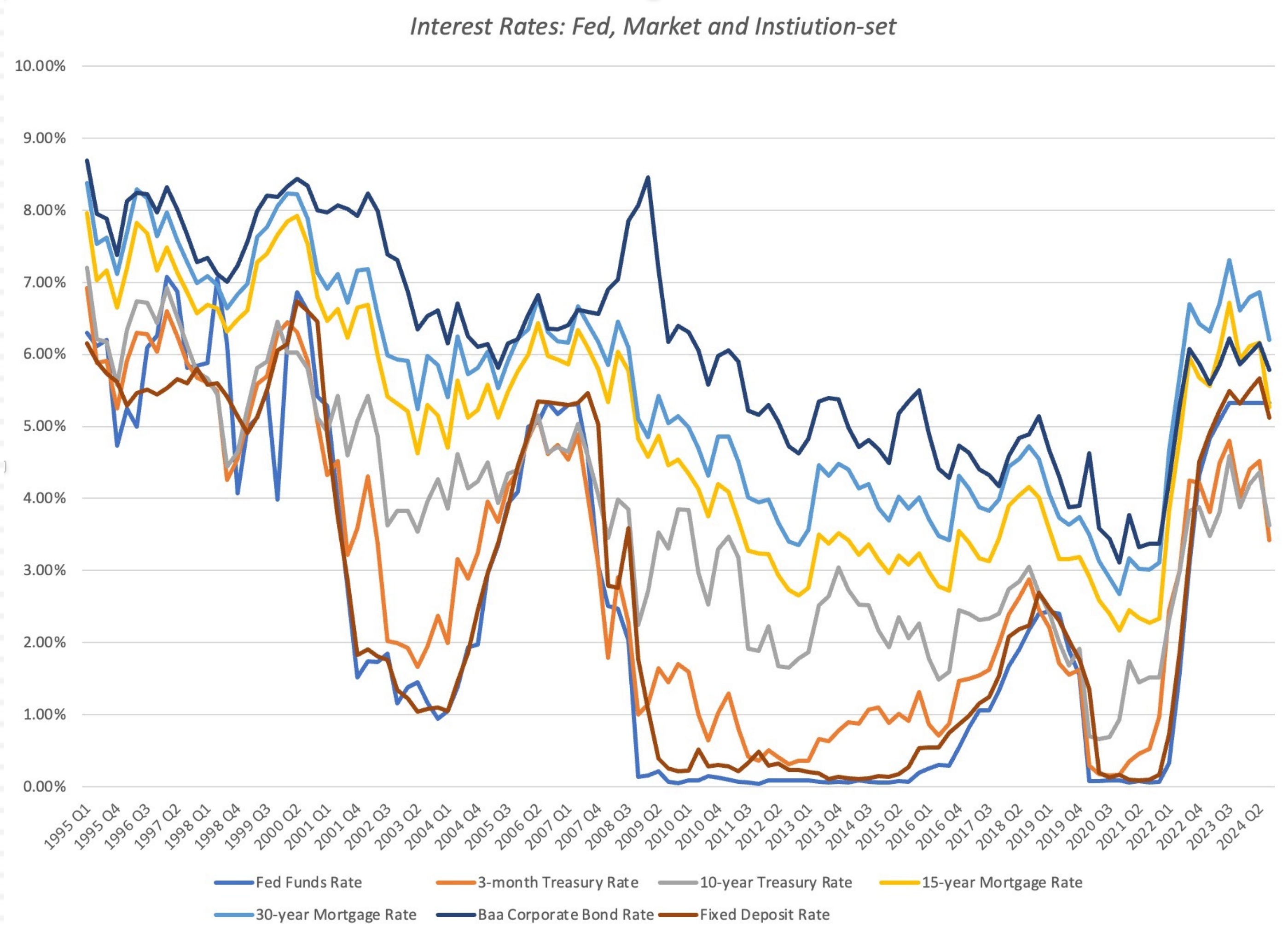
Institution-set Rates



2. The Fed as Rate Leader

- Even if you accept that the Fed does not set the interest rates that we face as consumers and businesses, you may still believe that the Fed influences these rates with these changes.
- Thus, in your world, a rise (fall) in the Fed Funds rate will trigger subsequent rises (falls) in both market-set and institution-set rates.
- The Fed, with its superior data and skills, is the market leader in this world, at least when it comes to interest rates.

The Superficial Backing…



A Better Test: Fed Funds Rate Changes & Market Interest Rate

		Change in 3-month Treasury (following quarter)			
Effective Fed Funds Rate	*Number of quarters*	*First Quartile*	*Median*	*Third Quartile*	*% of time increase*
Increase	96	-0.63%	-0.02%	0.39%	47.92%
Decrease	132	-0.27%	0.11%	0.46%	56.82%
No change	21	-0.02%	0.06%	0.21%	66.67%

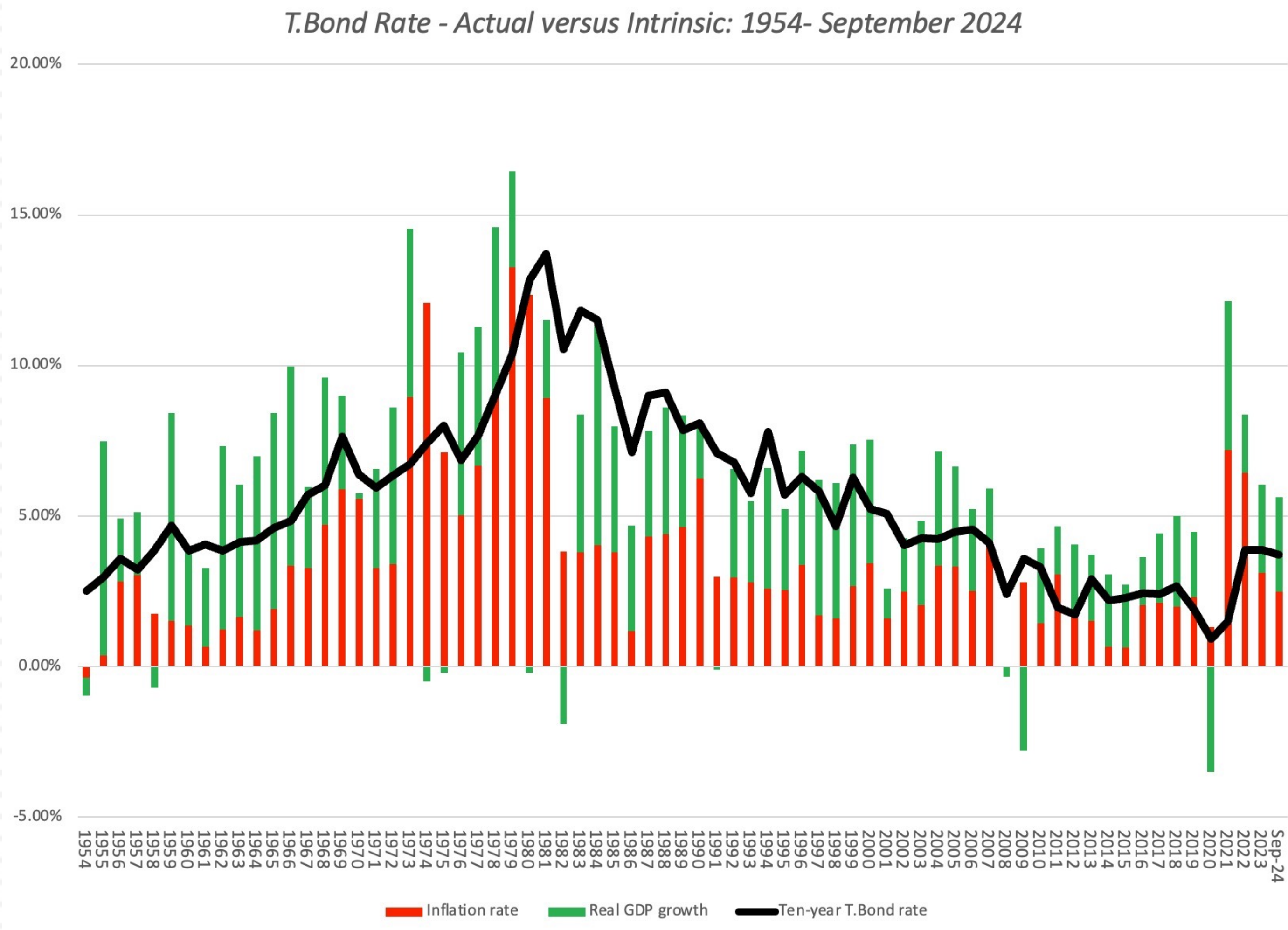
		Change in 10-year Treasury (following quarter)			
Effective Fed Funds Rate	*Number of quarters*	*First Quartile*	*Median*	*Third Quartile*	*% of time increase*
Increase	96	-0.39%	-0.01%	0.34%	46.88%
Decrease	132	-0.29%	0.07%	0.39%	56.06%
No change	21	0.00%	0.07%	0.30%	71.43%

Fed Funds Rate Changes and Other Interest Rates

		Change in 15-year Mortgage Rate (following quarter)			
Effective Fed Funds Rate	*Number of quarters*	*First Quartile*	*Median*	*Third Quartile*	*% of time increase*
Increase	45	-0.29%	-0.13%	0.08%	33.33%
Decrease	61	-0.29%	-0.06%	0.32%	44.26%
No change	12	-0.19%	0.11%	0.28%	58.33%

		Change in Fixed Deposit Rate (following qtr)			
Effective Fed Funds Rate	*Number of quarters*	*First Quartile*	*Median*	*Third Quartile*	*% of time increase*
Increase	45	-0.27%	-0.05%	0.03%	31.11%
Decrease	61	-0.02%	0.09%	0.41%	70.49%
No change	12	-0.07%	-0.02%	0.17%	33.33%

But the Fed kept interest rates low last decade, right?



3. The Fed as Signalman

- If you are willing to accept that the Fed does not set rates, and that it does not lead the market on interest rates, you may still argue that Fed rate changes convey information to markets, that may lead them to reprice bonds and stocks.
- It is undeniable that the Federal Reserve, with its twelve regional districts acting as outposts, collects data about the economy that become an input into its decision making. It is signaling, with its Fed Fund rate changes, what it has learned from that data.
- That said, there are two major macroeconomic dimensions on which the Fed collects data, with the first being real economic growth (how robust it is, and whether there are changes happening) and inflation (how high it is and whether it too is changing).

The Signals in the Fed Rate Cut

- You can see that there are two contrary reads of the Fed Funds rate cut of 50 basis points on Wednesdays.
  - If you are an optimist, you could take that to mean that the Fed is finally convinced that inflation has been vanquished, and that lower inflation is here to stay.
  - If you are a pessimist, the fact that it was a fifty basis point decrease, rather than the expected twenty five basis points, can be construed as a sign that the Fed is seeing more worrying signs of an economic slowdown than have shown up in the public data on employment and growth.
  - There is of course the cynical third perspective, which is that the Fed rate cut has little to do with inflation and real growth, and more to do with an election that is less than fifty days away.
- In sum, signaling stories are alluring, and you will hear them in the coming days, from all sides of the spectrum (optimists, pessimists and cynics), but the truth lies in the middle, where this rate cut is good news, bad news and no news at the same time.

4. The Fed as Equity Market Whisperer

- It is entirely possible that you are with me so far, in my arguments that the Fed's capacity to influence the interest rates that matter is limited, but you may still hold on to the belief that the Fed's actions have consequences for stock returns.
- In fact, Wall Street has its share of investing mantras, including "Don't fight the Fed", where the implicit argument is that the direction of the stock market can be altered by Fed actions.
- There is some basis for this argument, and especially during market crises, where timely actions by the Fed may alter market mood and momentum.

In non-crises periods, the Fed's effect on stock prices is…

If you remove the Fed's role in crises, and focus on just its actions on the Fed Funds rate, the effect of the Fed on equity market becomes murkier.

		Change in S&P 500 (following quarter)			
Effective Fed Funds Rate	*Number of quarters*	*First Quartile*	*Median*	*Third Quartile*	*% of time increase*
Increase	[illegible]96	-2.84%	2.85%	6.17%	65.15%
Decrease	[illegible]32	-1.30%	3.07%	6.47%	67.09%
No change	21	3.32%	5.52%	7.41%	92.31%

The Reality: The Fed as Chanticleer…

- There is an ancient story about a rooster named Chanticleer. Chanticleer was anointed the ruler of the farmyard that he lived in, because the other barnyard animals believed that it was his crowing every morning that caused the sun to rise, and that without him, they would be destined for a lifetime of darkness. That belief came from the undeniable fact that every morning, Chanticleer's crows coincided with sun rise and daylight. The story now takes a dark turn, when one day, Chanticleer sleeps in and the sun rises anyway, revealing his absence of power.
- The Fed (and every other central bank) in my view is like Chanticleer, with investors endowing it with powers to set interest rates and drive stock prices, since the Fed's actions and market movements seem synchronized.
  - As with Chanticleer, the truth is that the Fed is acting in response to changes in markets rather than driving those actions, and it is thus more follower than leader.
  - That said, there is the very real possibility that the Fed may start to believe its own hype, and that hubristic central bankers may decide that they set rates and drive stock markets, rather than the other way around.

The Fed Delusion: Time to let go?

- I know that this post cuts against the grain, since the notion that the Fed has superpowers has only become stronger over the last two decades. Pushed to explain why interest rates were at historic lows for much of the last decade, the response you often heard was "the Fed did it".
  - Active investors, when asked why active investing had its worst decade in history, losing out to index funds and to passive investors, pointed fingers the Fed.
  - Market timers, who had built their reputations around using metrics like the Shiller PE, defended their failure to call market moves in the last fifteen years, by pointing to the Fed.
  - Economists who argued that inverted yield curves were a surefire predictor of recessions blamed the Fed for the absence of a recession, after years of two years plus of the phenomena. How convenient?
- I believe that it is time for us to put the Fed delusion to rest. It has distracted us from talking about things that truly matter, which include growing government debt, inflation, growth and how globalization may be feeding into risk, and allowed us to believe that central bankers have the power to rescue us from whatever mistakes we may be making.