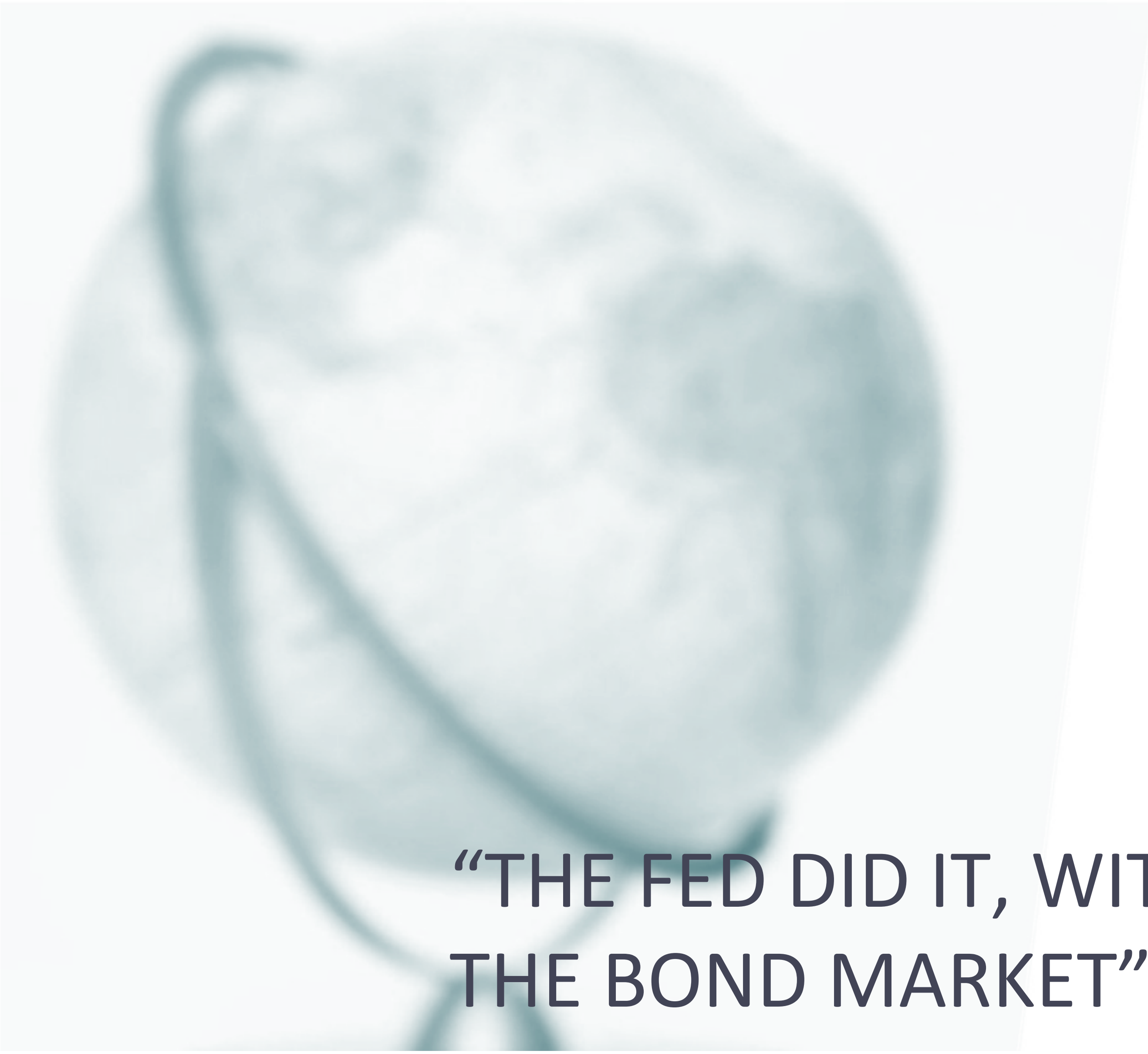


“THE FED DID IT, WITH QE, IN THE BOND MARKET”

Myths about central banks & why we believe them..

The answer to the Market game of Clue!

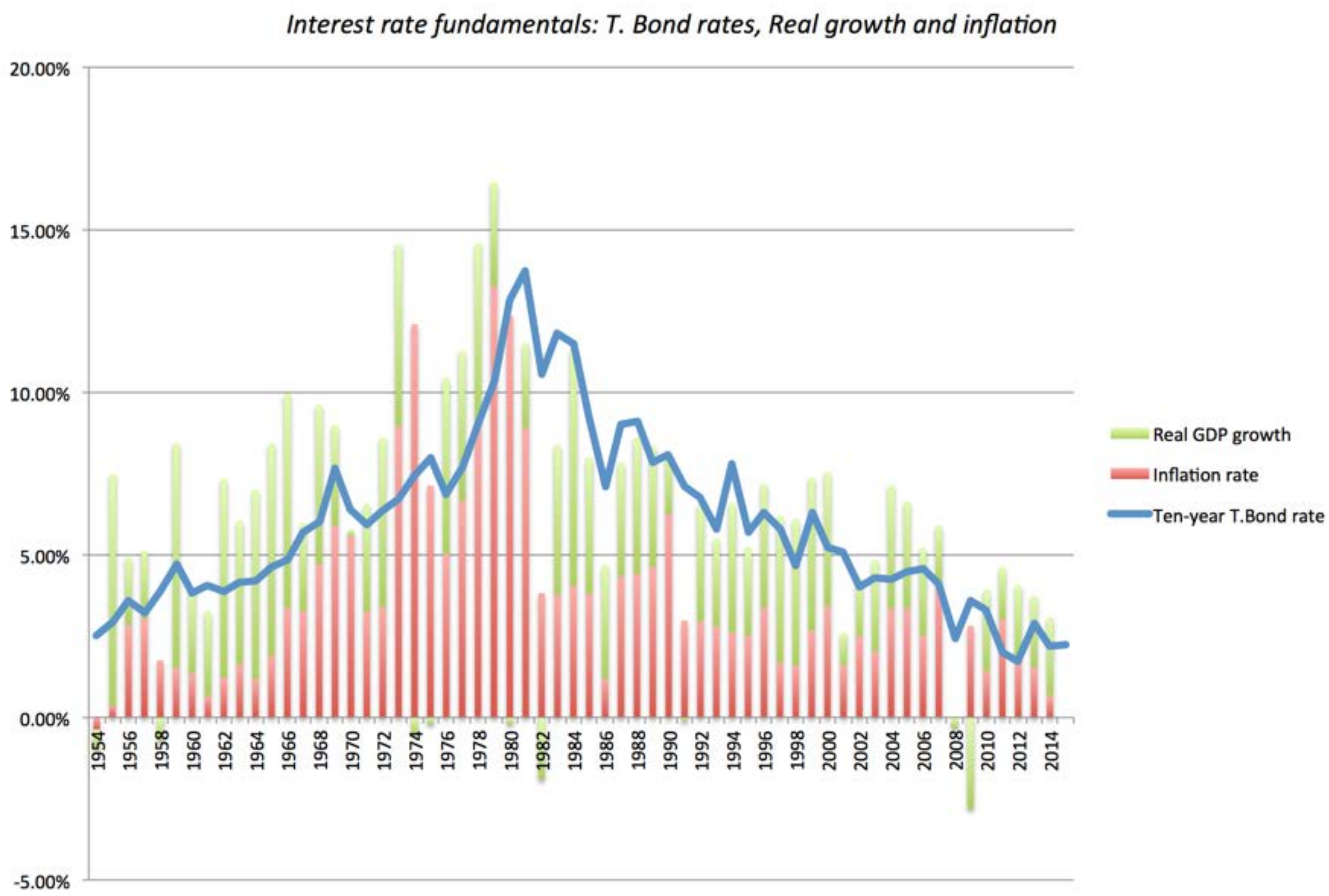
Four myths about the Fed (and central banks)

1. The Fed sets interest rates
2. The Fed has kept interest rates low for the last six years.
3. Low interest rates are the primary reason for stocks doing well over this period.
4. The biggest danger to the Fed is that the market will react badly to a change in its interest rate policy.

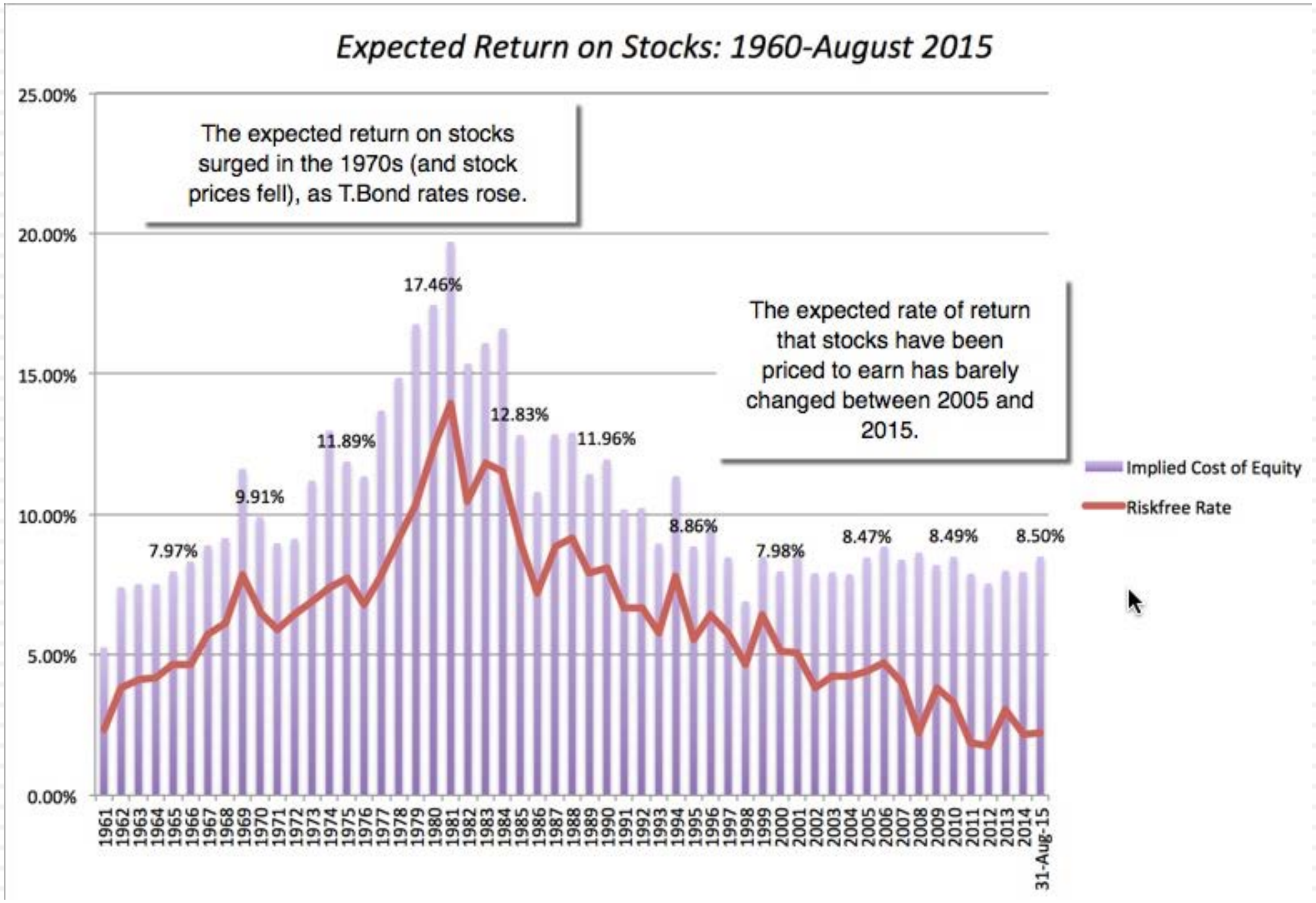
1. The only interest rate that the Fed sets is the Fed Funds rate..

- Given what we read about the Fed and its role in setting interest rates, it is no surprise that there are some who believe that the Fed explicitly or implicitly sets every interest rate that we observe in the market place.
- In reality, the Fed sets only one rate, the rate at which banks can borrow at the Fed window, and has direct influence on only one other rate, the Fed Funds rate, the rate at which banks borrow and lend over night in the Fed Funds market.
- The Fed funds rate has its strongest connection to short term market interest rates but even that connection depends on how the market views Fed moves. The connection to longer term rates is much weaker and rests more on fundamentals.

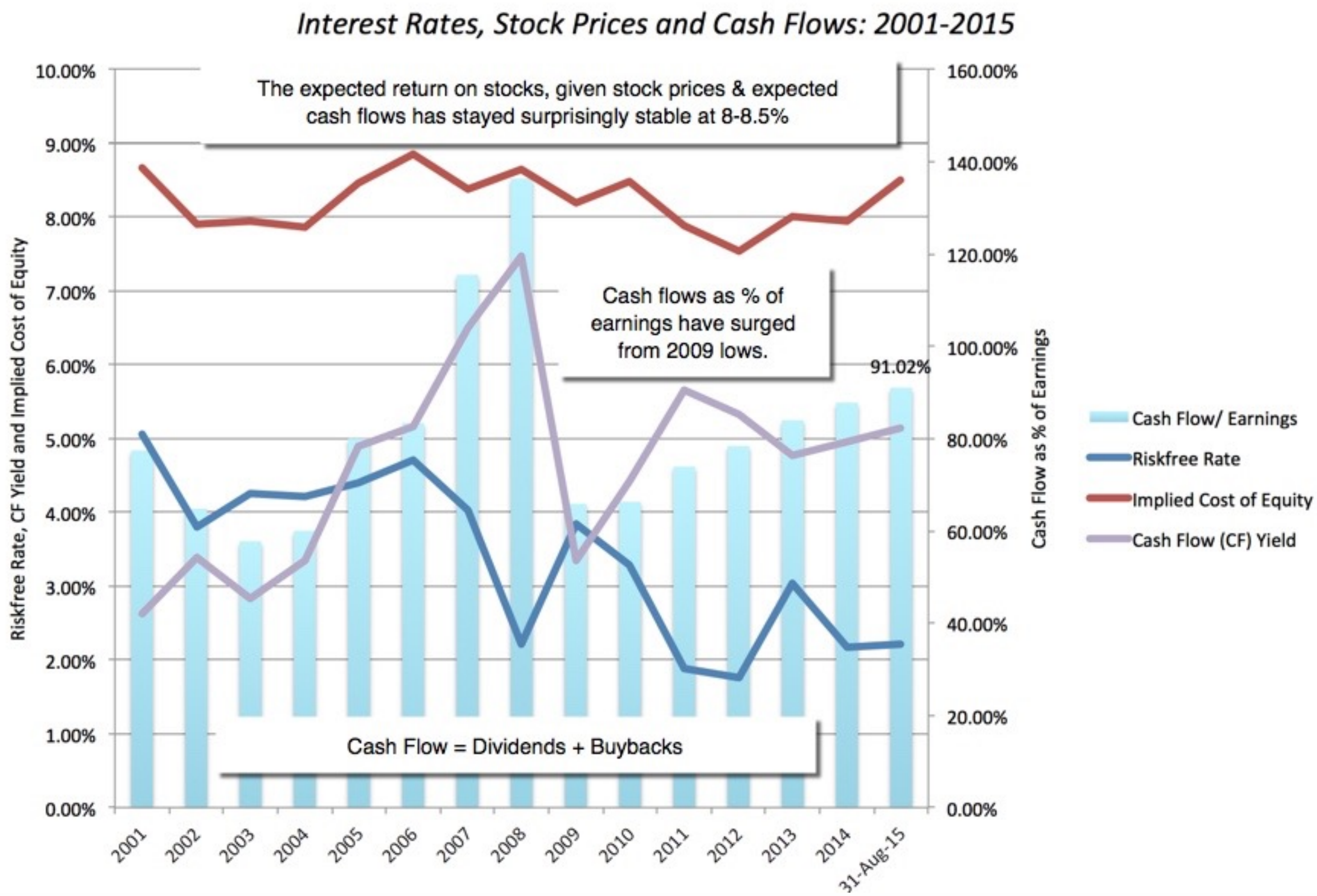
2. The real reason interest rates have been low over the last few years..



3a. The real reason for the bull market is not lower expected returns on stocks



3b. It is the cash flows!



3c. And the biggest danger to stocks is..

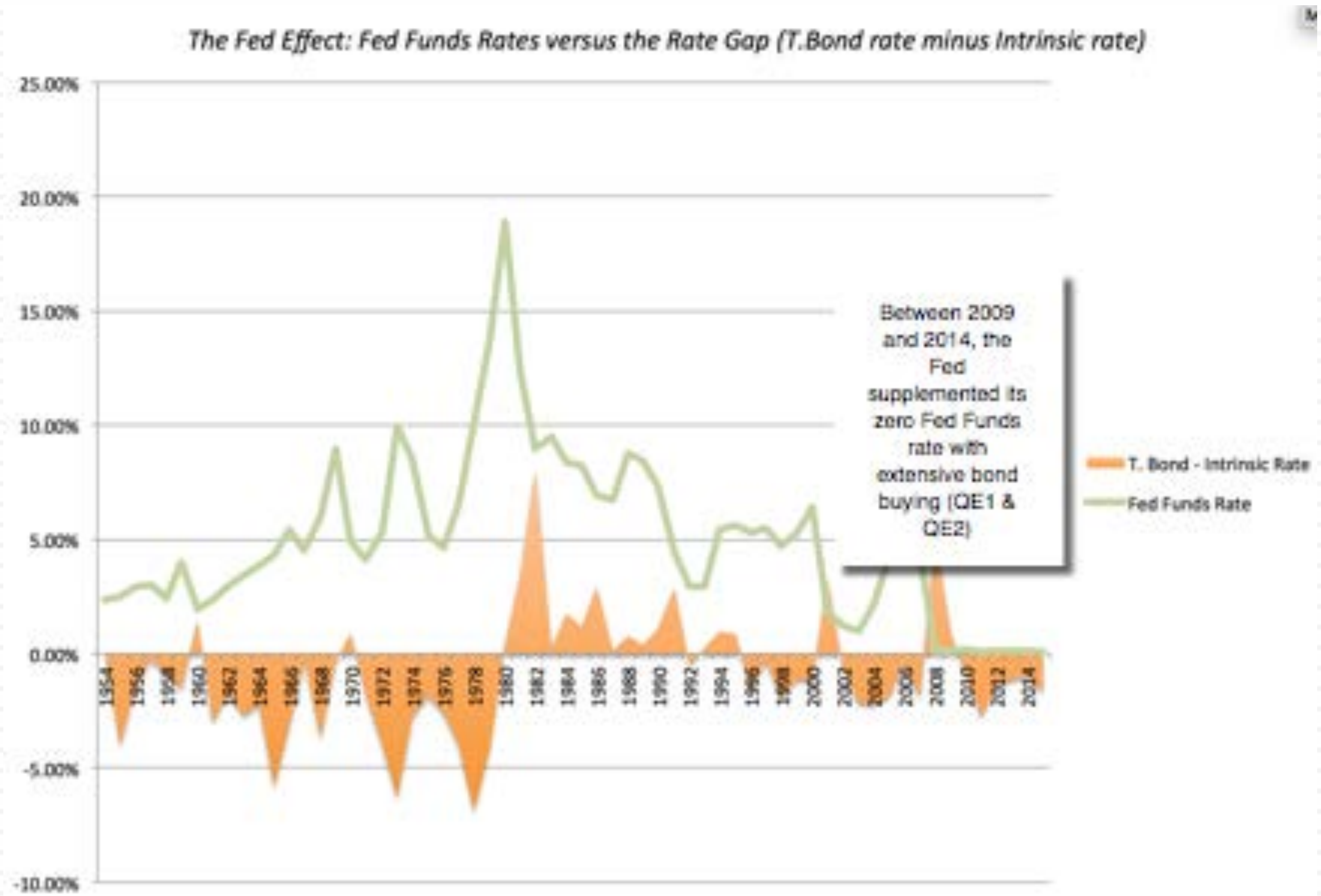
US T. Bond Rate		*Expected Change in Cash flows to S&P equity investors*				
		No change	*-5%*	*-10%*	*-15%*	*-25%*
	No change	0.00%	-5.00%	-10.00%	-15.00%	-25.00%
	2.5%	-0.78%	-5.74%	-10.70%	-15.66%	-25.59%
	3.0%	-2.45%	-7.33%	-12.20%	-17.08%	-26.84%
	3.5%	-4.08%	-8.87%	-13.67%	-18.47%	-28.06%
	4.0%	-5.67%	-10.39%	-15.11%	-19.82%	-29.25%
	5.0%	-8.76%	-13.32%	-17.88%	-22.44%	-31.57%

4. The Fed's biggest fears should be..

The conventional wisdom is that the Fed's biggest fear, if it changes interest rate policy, is that bond and stock markets will react badly. That may very wll be so, but I think that what would be more damaging to the Fed is one of the following:

- That it changes interest rate policy and markets ignore it; interest rates don't surge and stock prices don't plummet.
- That it does not interest rate policy and interest rates go up anyway.

The Fed has power..



But that power stems from its credibility..

- The Fed’s power stems from the perception that its acts reflect what it sees in the economy (perhaps with a little more information than the rest of us) and that it will move quickly if it sees inflation picking up.
- For this power to persist, the Fed has to be viewed as independent and consistent.

So, what's coming?

- The three big questions that hang over the market are:
  1. Will the Fed change interest rate policy change or not?
  2. Will that policy change affect interest rates or not?
  3. Will the interest rate change, if it occurs, affect stock prices or not?
- As an investor, I want the Fed circus to end. Obsessing on the Fed and what it will do has led us to ignore the fundamentals that drive the market and become an easy excuse for bad investment choices. It is time for all of us to move on.