The Chance Financial Quarterly

Well, as I told you previously, the market was up nicely through the 2nd quarter of this year, but the 3rd quarter was not good. The S&P 500 fell 3.7%. Unless you were into oil stocks, you did poorly. That said, the market is up 11.7% for the year, and that is roughly the long-run average return. While it would be nice to make up for last year's crappy performance, it's difficult to picture that happening under the current policies of both the administration and the Fed. I'll be pleased if the market is flat in 4Q and we can claim this year was an average year, instead of a below average one.

On the economic front, 2nd Quarter GDP, or Gross Domestic Product, a measure of economic activity, came in at 2.1%, about what it was in the first quarter. A good strong healthy economy ought to be growing at around a 3-4% rate. And therein lies much of the problem. The Fed thinks we have an overheated economy that is causing inflation. While we saw ridiculous levels of inflation last year, that seems to have waned. Last month it came in at 3.7%, which was an uptick from the prior month but still not too bad. We need to get it down a bit more.

Because the Fed thinks our economy is overheated and that this is causing inflation, it is pursuing a policy of making interest rates be high to choke off borrowing. So, it hiked rates again in July. That's 12 in 18 months.

In the Teaching Moment below, I explain what it means when the Fed is raising interest rates. This quarter they did it again and unlike Britney Spears, who at least said "Oops," the Fed did it on purpose. This was the 12th hike in 18 months, which is sort of like shooting at a duck 12 times in the hope that you'll eventually hit it. The Fed also signaled that we are likely to be in this period of high rates for a lot longer than we thought. Apparently that duck is pretty elusive. Actually the Fed is just a bad shot. As I explain below, this is how incompetent bureaucrat economists punish us for years of their poor policies of high government spending and interest rates so low that money was almost free. The rate on U. S. Treasury bills, which will be close to what you get on your money market deposits, is now around 5.2%, which is the highest it's been since 2000. As I said, this is to punish us for all those years of microscopic rates. The average rate on 30-year mortgages is more than 8%. Hope you're not buying a house right now. This is insane.

Let's be clear. The economy Is not overheated. Unemployment is about 3.8%, around where it has been since last December, when the Covid recovery really began to kick in. This is about as low as it's been in 20 years. GDP, as noted, needs to start moving up more, and it would do that with a lowering of interest rates. It just makes no sense for the Fed to keep tightening. Until it sends a signal that it will push rates down a bit, expect a stagnant market. As I said, let's be happy if we hold on to a double digit return this year.

Unfortunately, we can never separate politics from economics. The Democrats will continue to claim that their policies are working. The Republicans will argue that they aren't. I see half truths and half lies in both. You can rest assured that the White House will put pressure on the Fed to lower interest rates soon to give the economy a boost and put a charge in the market as the election season heats up. The Fed is supposed to be non-political and immune from pressure from politicians. Don't believe it.

The economy is neither weak nor strong. It just is what it is, somewhere in between. Interest rates are the outlier. The Fed needs to get rates down to where U. S. treasury bills are paying about 3%. That's along way down from the current rate. That's my opinion, but they don't ask me.

We citizens are required to take our punishment for what know-it-all economists did over the last 15 years. Just make sure you don't leave a lot of cash sitting around. If you're not comfortable with the stock market, make sure it's in money market funds, so you can get the 5% or so you deserve.

A Teaching Moment: What is this Thing the Fed Does?

Often we hear that the Fed, or Federal Reserve System, is raising or lowering interest rates. Here I'll explain what this means. It's important because it determines the rates you pay on loans and receive on savings.

Created in 1913, the Federal Reserve System, or Fed, serves as a banker to banks. The Fed has a few basic duties such as operating a check clearing and payments system, selling newly issued government bonds, and lending to banks that can't borrow elsewhere.

The Fed is charged with controlling inflation, which happens when there is too much money in circulation. This occurs from excessive federal spending and low interest rates, which we have had for about 15 years. These absurdly low rates, well below the long-run average, have been poor Fed policy and have now led to absurdly high rates, well above the long-run average. That's how we get our long-run average level of rates: too low, then too high. Rarely just right.

Now, banks cannot lend out every dollar deposited. They know how much they'll need to meet outflows. In addition, they are required to keep reserves, which can include vault cash and deposits at the Fed. On a given day, some banks have too much on deposit at the Fed and some have too little. The banks that are short money borrow it from the banks that have too much. The rate on such loans reflects the supply and demand of this money and is called the *Fed funds rate*. The Fed monitors this rate and attempts to keep it within a desired range. When it is trying to bring down inflation, it takes actions to raise that rate to discourage borrowing.

It does this by engaging in an activity called *open market operations*. Both the Fed and banks hold federal government debt. When the Fed wants to raise interest rates, it sells bonds to banks by offering attractive prices that induce banks to buy the bonds. This reduces how much money banks have to lend, thereby substituting government bonds for loans they might have made with the money.

Result: The rates we pay on loans and receive on savings go up. It's how the Fed punishes us for poor monetary and government spending policy that caused the inflation in the first place. Remember: when they screw up, we pay. And you might have noted that instead of lending to us, the banks are still lending. They're just lending to the government.

When trying to drive rates down, the Fed buys bonds from banks at attractive prices. Banks then receive cash from the Fed and they have more to lend. Rates go down.

Interestingly, journalists often tell you that the federal government funds deficits by printing more money. Sometimes these idiots even say that the government turns on the printing presses.

Maybe they believe it, but it's not true. Currency is a small fraction of the money supply. The government simply borrows the money by issuing bonds.

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Don Chance, PhD, CFA holds the James C. Flores Endowed Chair of Financial Services and is Professor of Finance at Louisiana State University. Any views expressed herein are his own and may not represent those of his employer. He likes to think of himself as an all-around nice guy who believes that the more knowledge he shares with others, the better investors people will become and the more likely they can avoid being ripped off by the Wall Streeters, who know many ways to take your money and make you think you came out ahead.