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# THE CHANGING FACE OF THE FEDERAL RESERVE?

Eagle's Todd McCallister offers his perspectives on where the Fed goes from here as the economy works through The Great Recession.


## EXECUTIVE SUMMARY

- Portfolio Manager Todd McCallister, PhD, CFA, is more than just a Federal Reserve observer. He earned a doctorate in economics from – and later taught the subject at – the University of Virginia.

- The Federal Reserve rightly stepped far out of its traditional role in trying to avert a global crisis by expanding existing programs and creating new ones in an effort to keep the nation's economic engines running.

- The question now is, How does the Federal Reserve resume its historical role when the global economies have stabilized?



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> **– Todd McCallister, PhD, CFA,**
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> Eagle portfolio manager and former economics professor

The Federal Reserve went to extraordinary means over the last couple of years to try to avert a total collapse in the U.S. economy. It was a radical departure for the Federal Reserve, which historically has operated behind the scenes, said Eagle's Todd McCallister, PhD, CFA, a portfolio manager who has more than a passing interest in the topic. He earned his doctorate in economics from the University of Virginia and later taught the subject there.

Federal Reserve Chairman Ben Bernanke was a student of the Great Depression and he wanted to avoid the mistakes – e.g., raising tax rates, raising interest rates and imposing import tariffs – government officials made then that exacerbated existing problems.

In doing so, though, Bernanke may well have changed not only the Federal Reserve's mission but the way it conducts business, said McCallister. One of the key historic operating principles of the Federal Reserve had been its independence: not beholden to any of the three branches of the federal government.

"It was – perhaps ironically, perhaps not – the least democratic organization in the U.S. government," said McCallister. The Federal Reserve focused solely on keeping the nation's economic engine running without regard to who sat in the White House or which party had a majority in Congress.

It did its work simply, "fueling" the economic engine by setting the federal funds interest rate at what it deemed an appropriate level and/or by selling or buy Treasury notes. The federal funds rate is the interest rate at which banks loan money to each other, usually for overnight loans (hence the sometimes-used phrase "overnight rate"). Lower rates are designed to encourage banks to make loans to each other while higher rates may make banks less willing to take on debt. The Federal Reserve pumps cash – liquidity – into the economy by selling Treasury notes (the U.S. government's version of selling an IOU) and can shrink the amount of money in circulation by buying back Treasury notes (paying back the IOU).

The role of central bankers, including at the U.S. Federal Reserve, changed dramatically on Oct. 8, 2008, when six of the world's major central banks, in a coordinated effort, lowered interest rates 50 basis points. (China separately lowered its rates also but to a lesser degree.) Further, the central bankers issued a joint statement outlining a message that the world's economies are increasingly interconnected and that the global slowdown was an international issue that must be dealt with globally.

Of course, the U.S. Federal Reserve did far more than simply lower interest rates to nearly zero percent. It invited banks to use the so-called

"discount window," which loaned funds directly from the Federal Reserve at a rate higher than the fed funds rate but not as high as would be found on the open market. It also instituted a whole host of programs designed to help banks with the intention of injecting more liquidity into a system that essentially had seized up.

It also created other programs to help shore up citizens' faith in the underpinnings of the country's economic system. It underwrote an insurance-type program for money-market funds to ensure their per-share value didn't drop below the mandated $1. It has underwritten mortgage programs. The Federal Reserve even agreed to pay interest on the required and excess reserves banks hold in the U.S. Treasury.

McCallister says there are some concerns about the neutrality of a Federal Reserve that now has established a precedent for tweaking the domestic economic engine through both quantitative measures (its historical preference via overnight rates) and qualitative measures (e.g., underwriting mortgages).

"The Fed is now in a position to decide which asset class it should subsidize," said McCallister. That kind of decision-making may be subject to political influence.

Those concerns may be valid but McCallister believes the Federal Reserve's top officials remain focused on moving the domestic economy – in conjunction with global economies – from the near-catastrophe of the last couple of years to a path of steady growth. They have plenty yet to keep them busy.

Businesses – even good businesses – need access to capital for short- and long-term needs, said McCallister. The Federal Reserve has done a good job of making money available to banks but they are not yet lending. The holdup has been that federal regulations require a bank to hold so much capital in relation to its outstanding loans. Banks have indicated they believe the worst of the credit crunch is behind us but, mindful of unpleasant surprises that may still be lurking, they are holding on to their cash rather than lending. (The Federal Reserve, remember, is paying interest on those unused surpluses.)

Economic students in the past may have heard their professor say, "Well, the government has issued all these bonds, has put so much capital into the system and has put so much debt on the books that, at some point (and maybe sooner than later), the Fed is going to have to raise interest rates to keep the economy from running into inflationary territory," said McCallister.

That may not happen for some time, he said. And the Fed has – in its efforts to help the broader economy (as is its mandate, McCallister noted) – crimped its ability to use an age-old trick to slow inflation: raising the fed funds rate.

"The Federal Open Market Committee (which sets the fed funds rate) knows that raising the rate now means costing itself – the public, really – large amounts of money," he said. That's because the federal government would, at the same time, have to increase the interest it pays on the approximately $1.5 trillion that various institutions have on reserve in the U.S. Treasury.

The long-term goal of the Federal Reserve remains getting the U.S. economy on track – along with those of countries around the world – and then being able to retreat to its mostly behind-the-scenes existence, said McCallister.

Todd McCallister was recently featured in a Barron's profile story.

*Click here to read the article.*

That may take some time, though, particularly as many financial companies "de-leverage" their balance sheets and untangle some nearly unfathomable investment programs; as the domestic residential and commercial real-estate markets re-establish "normal" after a bubble; and as individuals – who may have been caught in the downdrafts of both financial companies' missteps and plummeting real-estate values – try to clean up their own finances, said McCallister.

Equity markets would prefer a dramatic, V-shaped recovery that would allow investors to make back money they lost in the stock market just as quickly, he said. It might be far better for everyone over the long term for the Federal Reserve to foster a U-shaped recovery, said McCallister.

That would allow some financial companies to navigate through what is likely the home stretch of loan mark-downs; at the same time, it would allow many other financial companies to pay back money they borrowed from the Federal Reserve; it would allow individuals to get their finances in order; and it might help avoid, McCallister hopes, setting up another asset class (think technology, then real estate, then oil) as a bubble-that-will-burst.

Finally, it would allow the Fed - in an orderly way – to shut down programs it started to staunch an economic collapse and withdraw itself from its multi-front role to its historical role as economic "fireman," making sure there's just enough coal in the firebox.

An important thing to remember is that a recovery – even a slow one – is a recovery nonetheless, said McCallister.

The role of the Federal Reserve is important mostly on a macroeconomic level. It's vital not to be completely unaware of what the Fed is doing but most investors are better served to pay attention to their financial goals and plans, which they should discuss with a financial advisor. The investor and advisor can work together to achieve an asset-allocation plan that they believe will help achieve those goals.

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880 Carillon Parkway | St. Petersburg, FL 33716 | 800.237.3101 | 727.573.2453

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