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THE FEDERAL RESERVE VS. CAPITALISM

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The central bank of the United States—*The Federal Reserve*—has dominated financial headlines for decades. Sometimes "the Fed" is cast as the hero, while other times it is cast as the villain. Business owners and investors do their best to predict the impact of each Federal Reserve policy announcement, as if they are sailing tiny boats on a raging sea while the gods of monetary policy decide which way the wind will blow and the tides will flow. Perhaps it is not the role of the sailor to question the wind and the tide, but merely to navigate it the best that they can. Surely our central bank is a place where the smartest economic minds go to practice their profession.

Judging the Fed's performance in comparison to other central banks around the globe might lead us to believe that it has done a good job. The U.S. dollar is the currency of choice in global trade. Our economy is still the largest in the world, and the American share of the world's stock market continues to rise. Surely the Fed must deserve some of that credit, right? Well, maybe not. Maybe our economy would be performing even better without the Fed's "help." Maybe our standard of living would be higher. Maybe the gap between the "haves" and the "have nots" would be smaller.

The massive power of the Federal Reserve's policy choices have reordered the winners and losers in the American economy. The Fed's admitted failure to properly manage inflationary pressures during the pandemic era may be about to wreak havoc on the lower half of American wealth to such a degree that it could destabilize our economy and possibly our political structure. The remedy to this most recent series of policy blunders lies in the cornerstones of the American economy—capitalism and democracy. The Federal Reserve seems to have lost its faith in capitalism, although some might argue that the Fed's Board members are simply doing the job they were hired to do (albeit badly). Only our elected politicians can change the Federal Reserve's mandates. Until that happens, investors need to understand what the Fed is doing, and how to thrive financially despite these policies. **BIP Wealth's insights have helped to protect our clients all year, and we don't expect the choppy seas to calm anytime soon.**

> ***"For investors playing the long game, we know how this will turn out. We've seen a lot of stock market reversals in the past few decades of the Fed's activist policies, so we know that the move back up could come at any time. For now, it's important to know that our investment style is helping to mitigate the losses."***

It is easier to understand the Federal Reserve's most recent decisions if we remember back to mid-2019, before anyone had heard about COVID. Interest rates had been near zero for about a decade, even though the Great Recession was in the rearview mirror. Ever so timidly, the Fed had begun to raise interest rates and pare down its massive balance sheet. This made sense, and it should have happened years earlier. GDP growth had been running hot, bringing our economy's output right up to its potential maximum. The housing market was surging, and unemployment was at record lows. In other words, the economy was doing great.

Going into the fourth quarter of 2019, the MSCI ACWI IMI Global Equity Index was already up 15.87% for the year. The U.S. had been cutting taxes, instead of using our economic strength to pay down our rapidly growing national debt, and the market loved it. But for some reason the Fed suddenly reversed course and cut short-term interest rates again. On top of that, they began to increase the money supply and rebuild their balance sheet. We ended 2019 with a stock market rally and wondered when this might result in a massive spike in inflation.

But suddenly the world faced a new challenge, and the pandemic was upon us. And almost overnight, the reality of the economy changed to fit the wartime footing the Fed had already taken. Massive fiscal stimulus by Congress and the White House followed. It created extra unemployment benefits and the infamous Paycheck Protection Program that stuffed billions of dollars into the pockets

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of business owners. And in a matter of months, we were in and out of a recession. The stock market fell hard but recovered just as quickly. And as we wrapped up 2020, BIP Wealth once again voiced our concerns about a massive spike in inflation.

What happened next will be analyzed and written about by economists for years to come. We are living in a time that is re-writing the rules for monetary policy. Not only did the Fed keep its foot on the gas for way too long after the recession was over, in addition it simply failed to understand that the global supply chain was severely compromised. The evidence was everywhere, making life more difficult for business owners and consumers alike.

Economics students in their first semester learn how a demand curve and a supply curve cross to set the price and quantity of an economy. For some unknown reason, the Fed decided that the best reaction to a shifting supply curve, that was driving up prices all on its own, was to stimulate demand with lower interest rates and lots of new money. Prices began to quickly rise. The Fed was sure it would be "transitory," but it wasn't.

China announced a zero-tolerance policy that would go on to shut down major components of the world's global industrial production, and the Fed reacted again by pushing demand even higher, with even greater increases to our money supply. Russia invaded Ukraine, which compromised agricultural production and the availability of industrial supplies, and the Fed again pushed demand even higher. Western democracies sanctioned Russia, restricting energy supplies and further moving the supply curve towards higher prices. And the Fed pushed demand even higher, guaranteeing that inflation would set records not seen in four decades and creating an expectation that inflation was here to stay.

And that brings us to today, when inflation is embedded in the global economy. Because so much of the inflation problem is still being driven by problems with the supply chain, the ability of the Fed to do anything about it is in question. That's a real problem for the bottom half of the participants in our economy. In the past year, many costs have risen much faster than the headline inflation number of 8.2% at the end of September. According to the Bureau of Labor Statistics' recent report, in the last year the cost of health insurance was up 28.2%; the cost of public transportation was up 27.1%; the cost of gasoline was up 18.2%; the cost of electricity was up 15.5%; and the cost of food at home was up 13%.

In late September, the Federal Reserve raised overnight interest rates by another 75 basis points. To be specific, it moved the Federal Funds rate up to a range of 3.00% to 3.25%, which is the highest it has been since 2008. This is the third 75 bps move upwards in as many meetings. Their rational is that they are raising rates to cool the economy, and therefore to reduce the demand for goods.

Interest rates are probably about where they need to be, or maybe even a bit too high. There is an opportunity for the Fed to simply stop, and trust that a capitalist economy can work out the rest on its own without any more distortions from them. Instead, the most worrying part of the announcement of the recent rate increase was an additional statement of their intention to continue raising rates by another ~1.5%. What does this mean? It means that the cost of credit card debt will move even higher. It means that the Fed is determined to cool the employment market, potentially forcing millions of workers to lose their jobs. These are likely the same people suffering the most from inflation already, so it's hard to imagine how they will be better off without a job.

The Fed may even be determined to push us into a recession, in an effort to reduce the rate of inflation. This would mark the next chapter in their history of incompetence. Now that interest rates are back up, the inflation problem is being driven by the supply curve and not Fed policies. Many of the problems with the global supply chain could be remedied if China relaxes its pandemic protocols. A cessation of the conflict in Ukraine would also help. News of this nature could happen at any time, causing inflation expectations to plummet. If this were to happen, and the Fed has continued to raise rates, then they would likely need to immediately begin lowering rates to mitigate the damage they've caused.

For investors playing the long game, we know how this will turn out. We've seen a lot of stock market reversals in the past few decades of the Fed's activist policies, so we know that the move back up could come at any time. For now, it's important to know that our investment style is helping to mitigate the losses.

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