



Does the Federal Reserve control or set interest rates

Rob Brown, PhD, CFA

Julex Capital Advisory Board Member, Website www.robbrownonline.com



40 Grove Street, Suite 140, Wellesley, MA 02482

Phone 781-489-5398

Email info@julexcapital.com

Web www.julexcapital.com

- **Because**

- Journalists make it sound like they do
- Some financial advisors . . . speak the same way
- Our own investment industry . . . burns gigantic resources talking about what the Fed will or won't do next

- **This hurts our clients**

- Because they can only draw the worst possible conclusion
- i.e., that the Fed sets the level of interest rates

- **Misleading clients, encouraging them to believe in falsehoods . . . hurts everyone**

- Does the Federal Reserve set or otherwise determine the level of interest rates?
- Of course not **!!!**
- What a bizarre . . . otherworldly notion
- Driven by
 - Conspiracy theorists
 - And those who don't understand simple economics and the institutional structure of global capital markets

Size matters

Is the Federal Reserve big enough to even have an impact?

- Fidelity - Fixed income is the world's largest asset class. With an estimated value of over **\$200 trillion** globally . . . three times the size of the stock market
 - Federal Reserve - **\$8.9 trillion** is the current size of the Fed's balance sheet
 - So the fixed-income market is **22 ½ times larger than the Fed** . . . i.e., just 4.5% of the market
- Question if you owned 4.5% of the outstanding shares of Tesla . . . would you be able to set the price of Tesla stock in the marketplace?

What does the Fed control?

What are its primary tools

- Lending money for a couple of hours
- Attempting to twist the term structure of interest rates
- Expanding the money supply

Lending money for a couple of hours

Overnight lending facilities

The Fed Doesn't Have the Control Over Interest Rates Everyone Thinks It Does

Data suggests the Fed is more of a follower and less of a leader when it comes to interest rates.

JASON ORESTES • FEB 6, 2020 9:07 AM EST

Last week, the [Federal Reserve](#) did what was expected by leaving [their target](#) for the fed funds rate unchanged. To the point that a misplaced adverb can cause a mini market selloff, investors meticulously dissect Federal Open Market Committee minutes and hang on Fed Chair Jerome Powell's every word for language that provides insight into where the Fed may take interest rates. It's a near universal axiom that the Fed sets interest rates, and we're all just along for the ride.

How much control does it really have, though?

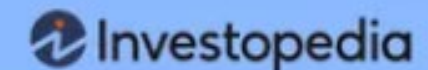
Firstly, it's not pedantic to point out the Fed doesn't actually directly control the [federal fund's rate](#); they only set a target range for it, implemented typically very well, via [open market operations](#) (though sometimes this rate does [get away from them](#)). The only interest rate the Fed has 100% under its own control is the [discount rate](#): the cost to borrow directly from the Fed itself. Neither of these are rates a normal person, or even a company, directly encounter. Both of these are overnight interbank lending rates banks incur to meet Fed-mandated [reserve requirements](#).



Federal Funds Rate

['fe-d(ə-)rəl 'fəndz 'rāt]

The target interest rate range at which commercial banks borrow and lend their excess reserves to each other overnight, which is set by the Federal Open Market Committee (FOMC).



How the Federal Discount Rate Works

In addition to its other [monetary policy](#) and regulatory tools, the Fed banks can lend directly to member banks and depository institutions. This is part of the primary purpose of the Fed as a lender of last resort to ensure the stability of the banks and the financial system in general. To prevent undue bank failures, **healthy banks** are allowed to borrow all they want at very short maturities **(usually overnight)** from the Fed's discount window, and it is therefore referred to as a standing [lending facility](#).

KEY TAKEAWAYS

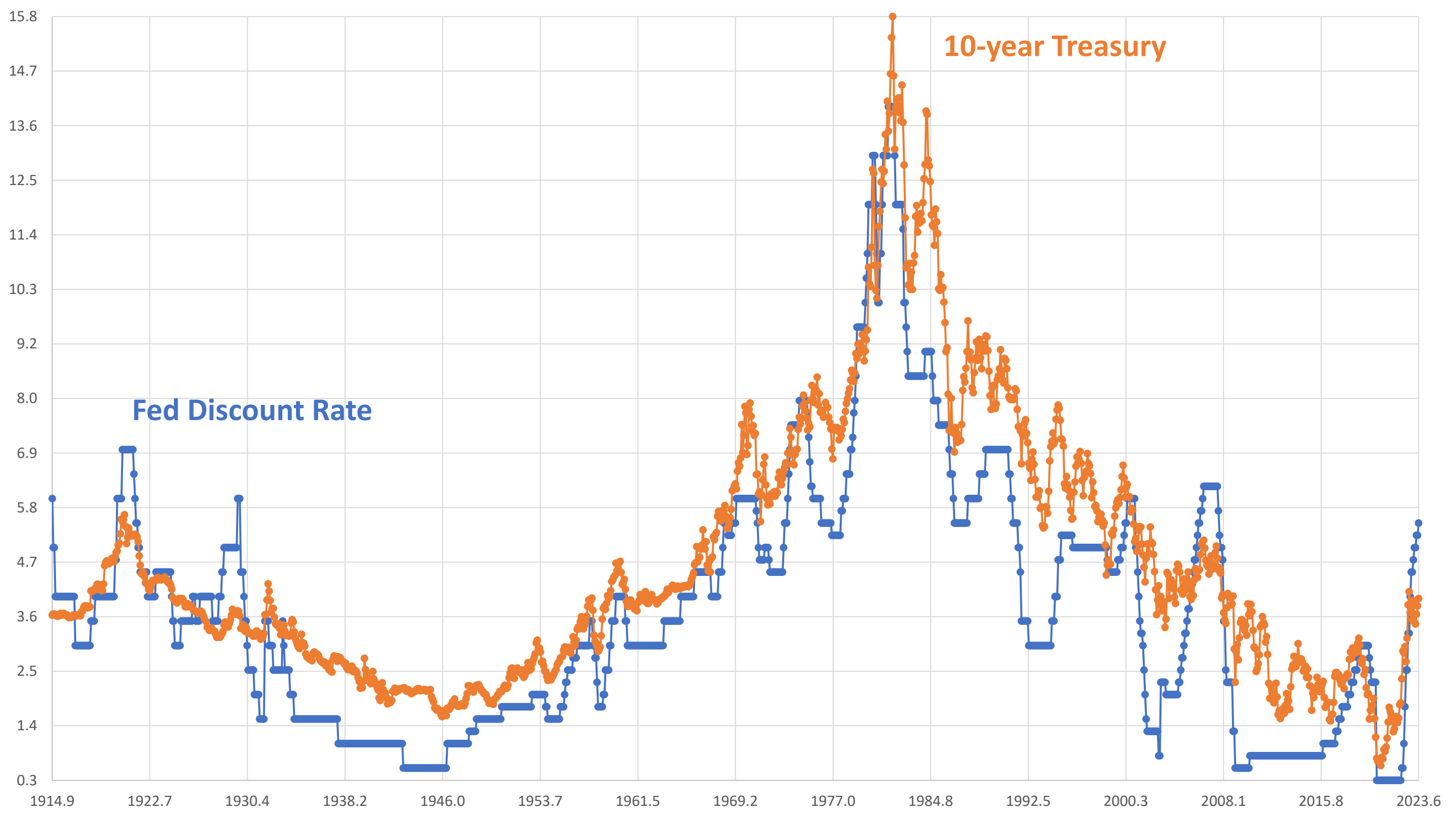
- The federal discount rate is the interest rate the Federal Reserve (Fed) charges banks to borrow funds from a Federal Reserve bank from the discount window.
- The Fed's discount rate is set by the Fed's board of governors, and can be adjusted up or down as a tool of monetary policy.
- Lending at the discount rate is part of the Fed's function as a lender of last resort, and is one of the Fed's primary monetary policy tools.

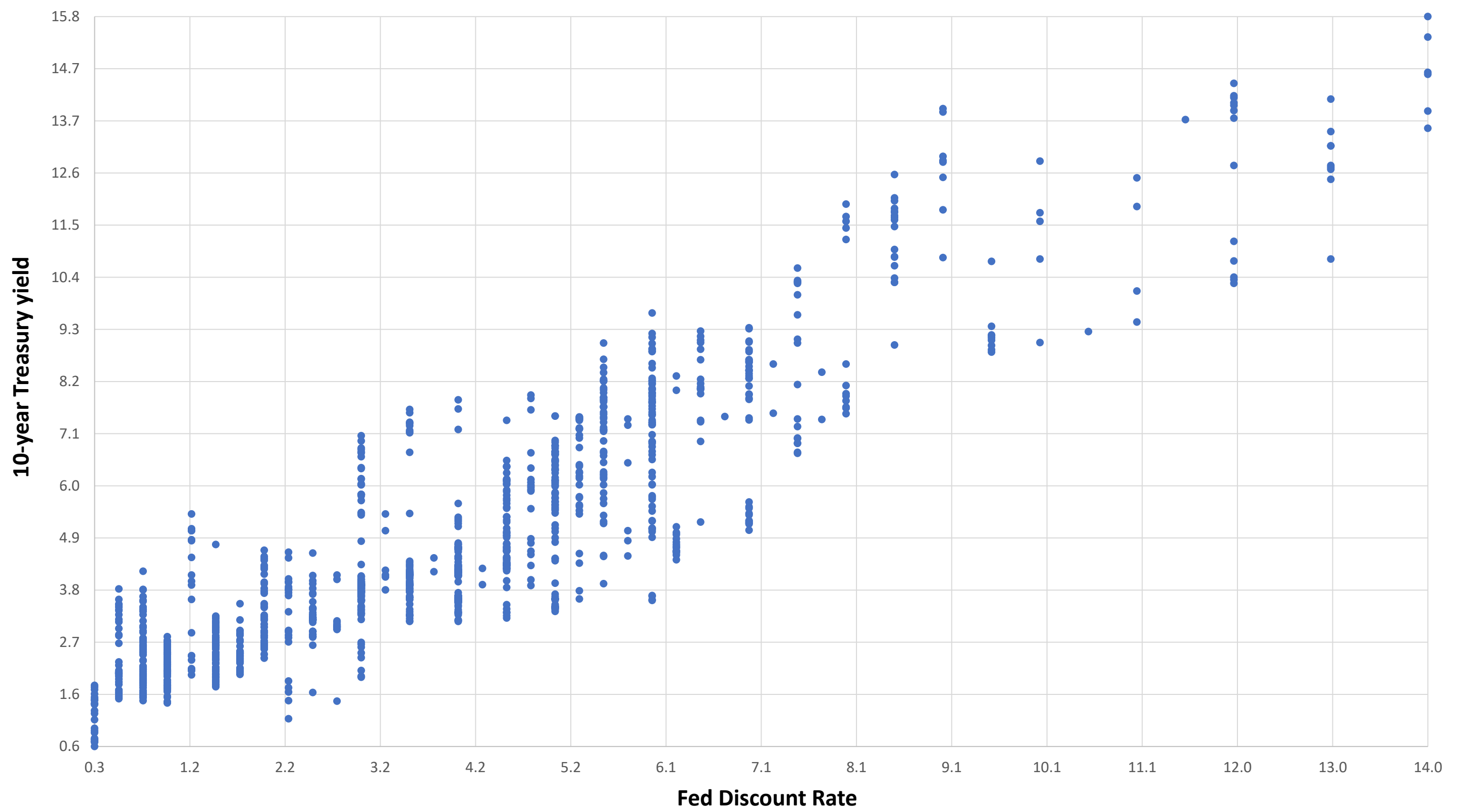
What does the Fed control (or set)

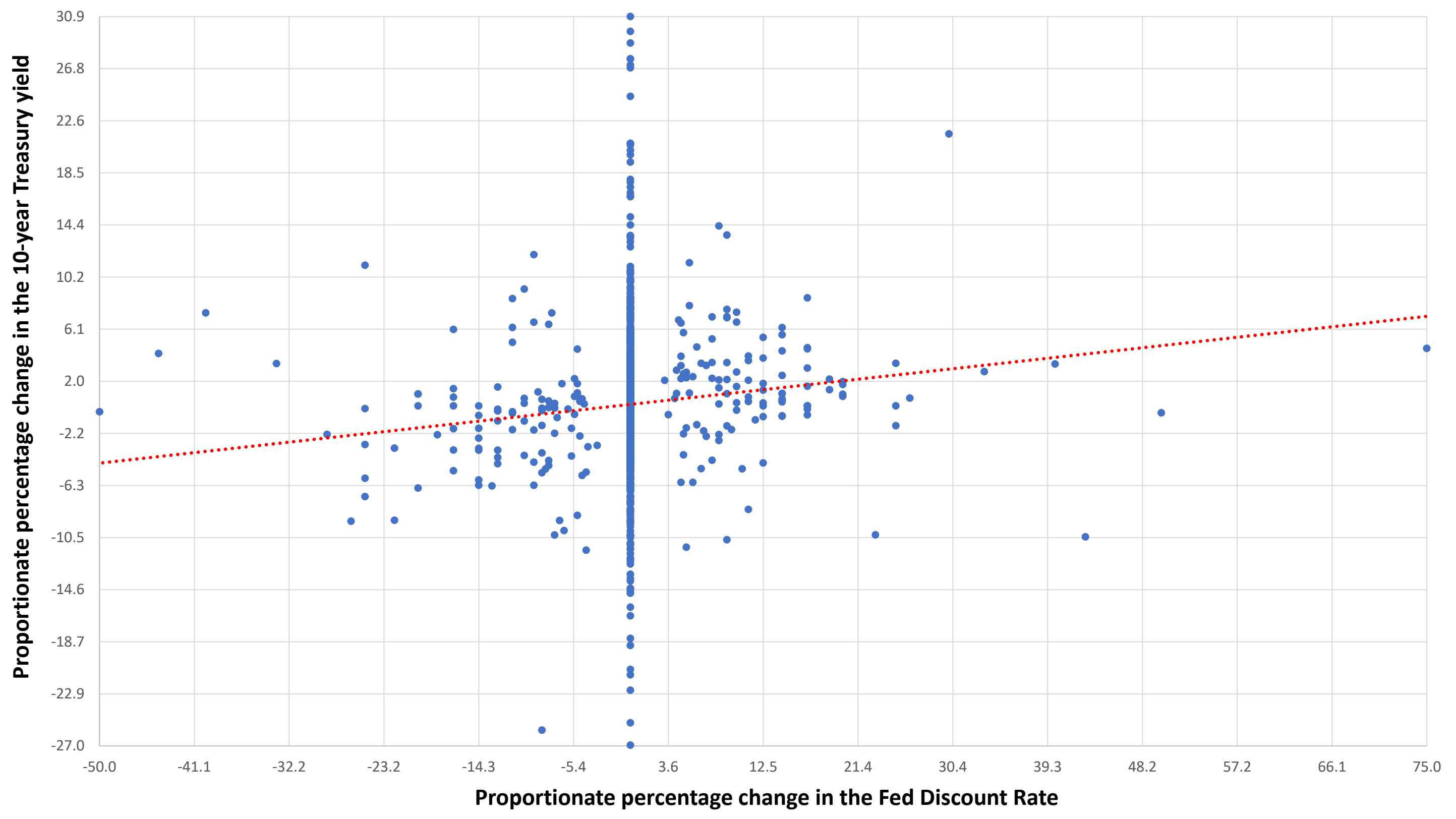
Two overnight inter-bank lending rates

- Healthy banks are allowed to borrow from the Fed
 - Overnight
 - At the Fed Discount Rate
- Rate is set by the Fed

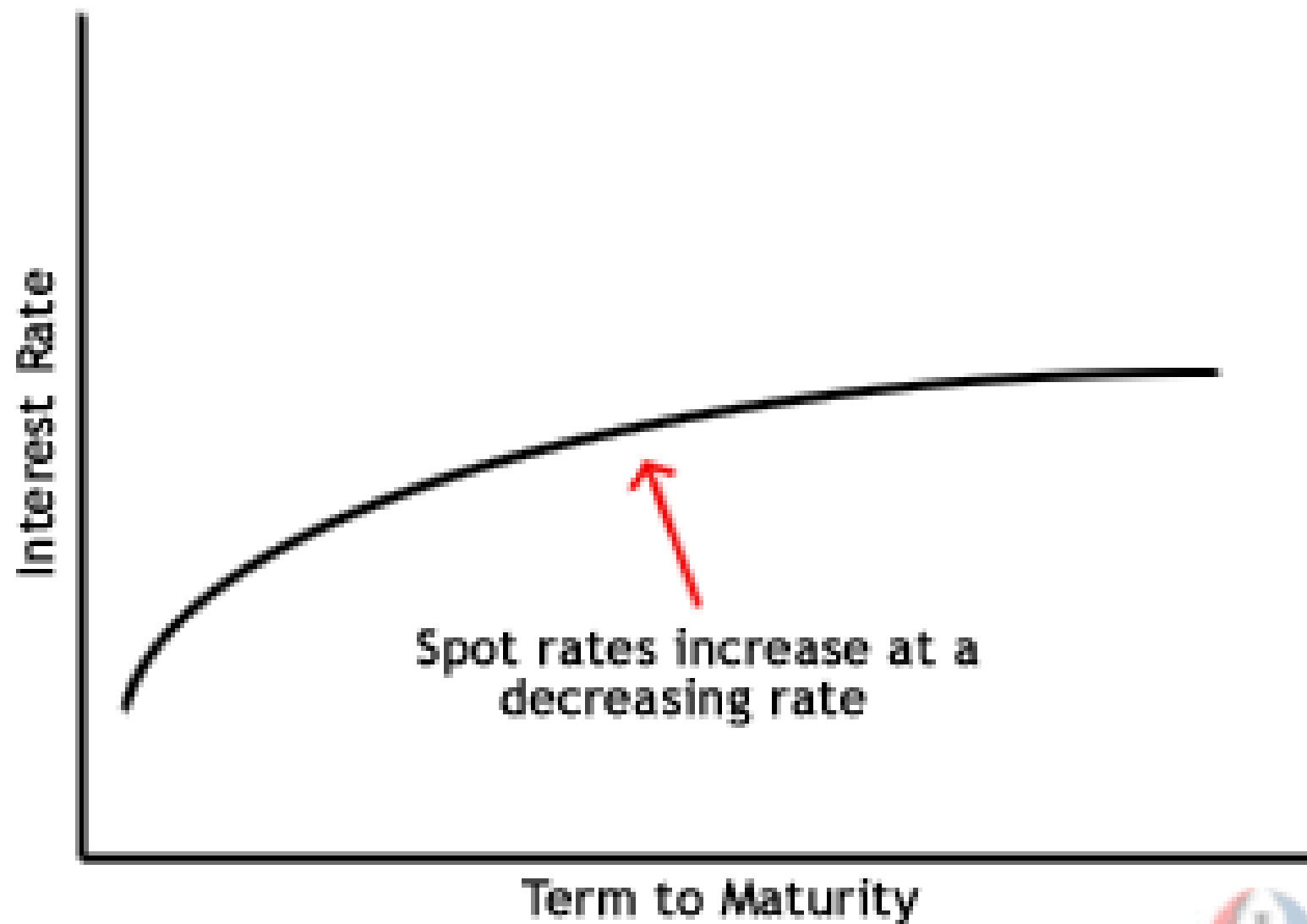
- **Commercial banks borrow/lend their excess bank reserves to each other**
 - Overnight
 - Rate is set by the marketplace . . . not the Fed
 - BUT . . . the Fed intervenes to keep that overnight interest rate within their Target Range . . . most of the time





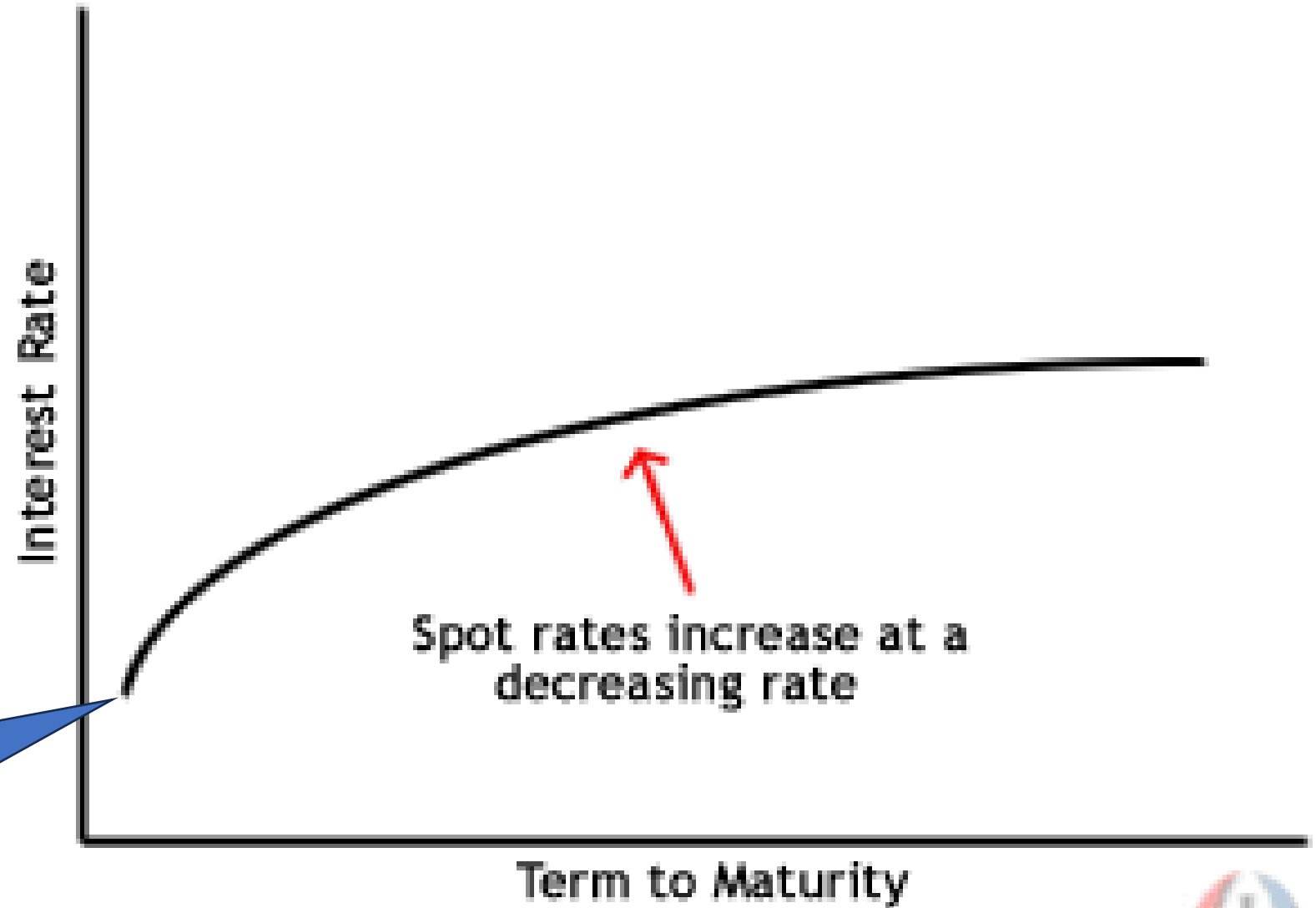


Term Structure of Interest Rates



Copyright 2003 - Investopedia.com





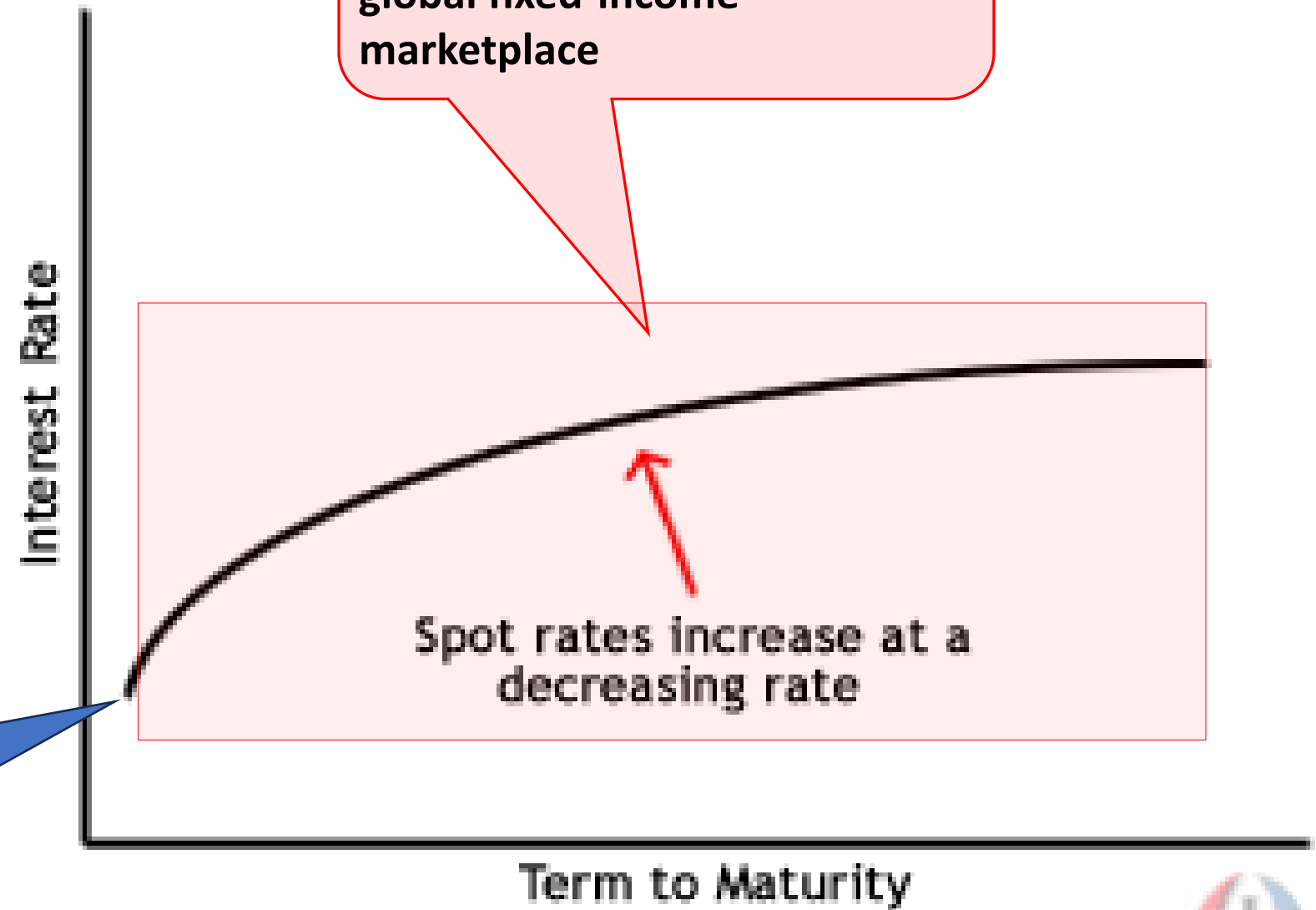
The Fed is able to literally set this one single tiny tiny end of the curve . . . And nothing else

Through the use of the Discount Rate and the Fed Funds Rate

Copyright 2003 - Investopedia.com



Term structure of interest rates



The Fed is able to literally set this one single tiny tiny end of the curve . . . And nothing else

Through the use of the Discount Rate and the Fed Funds Rate

Copyright 2003 - Investopedia.com



What happens when the Fed changes overnight rates?

If they **RAISE** overnight rates

- **Raising** overnight lending rates
- Short-term interest rates rise
- Middle-term interest rates stay unchanged
- **Long-term interest rates fall**
- **Why?**
 - The \$200 trillion fixed-income market believes
 - Economic growth will slow . . . Reducing demand for borrowing
 - Inflation will slow

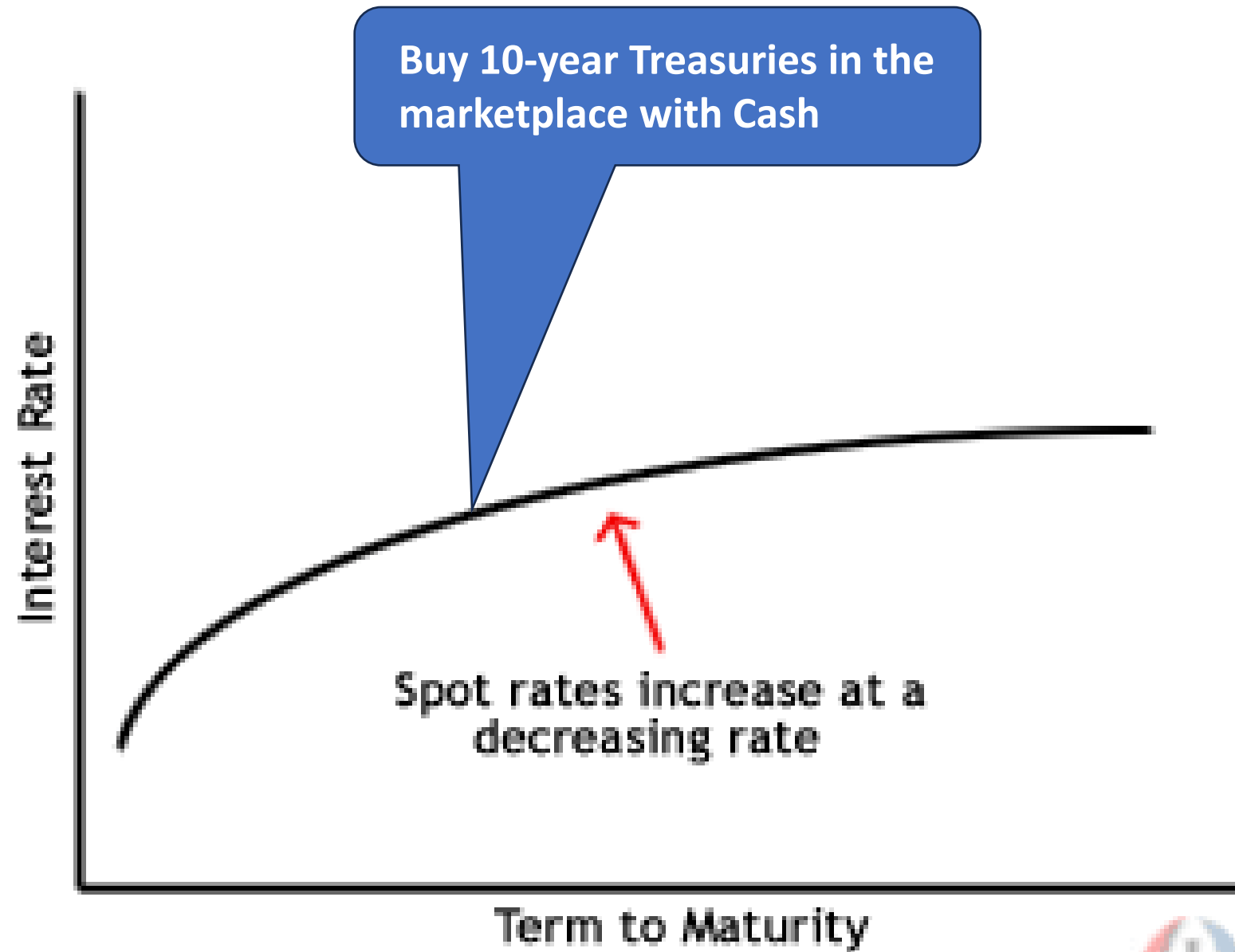
If they LOWER overnight rates

- Lowering overnight lending rates
- Short-term interest rates fall
- Middle-term interest rates stay unchanged
- Long-term interest rates rise
- Why?
 - The \$200 trillion fixed-income market believes
 - Economic growth will rise . . . Increasing demand for borrowing
 - Inflation will increase

- Lending money for a couple of hours
- Attempting to twist the term structure of interest rates
- Expanding the money supply

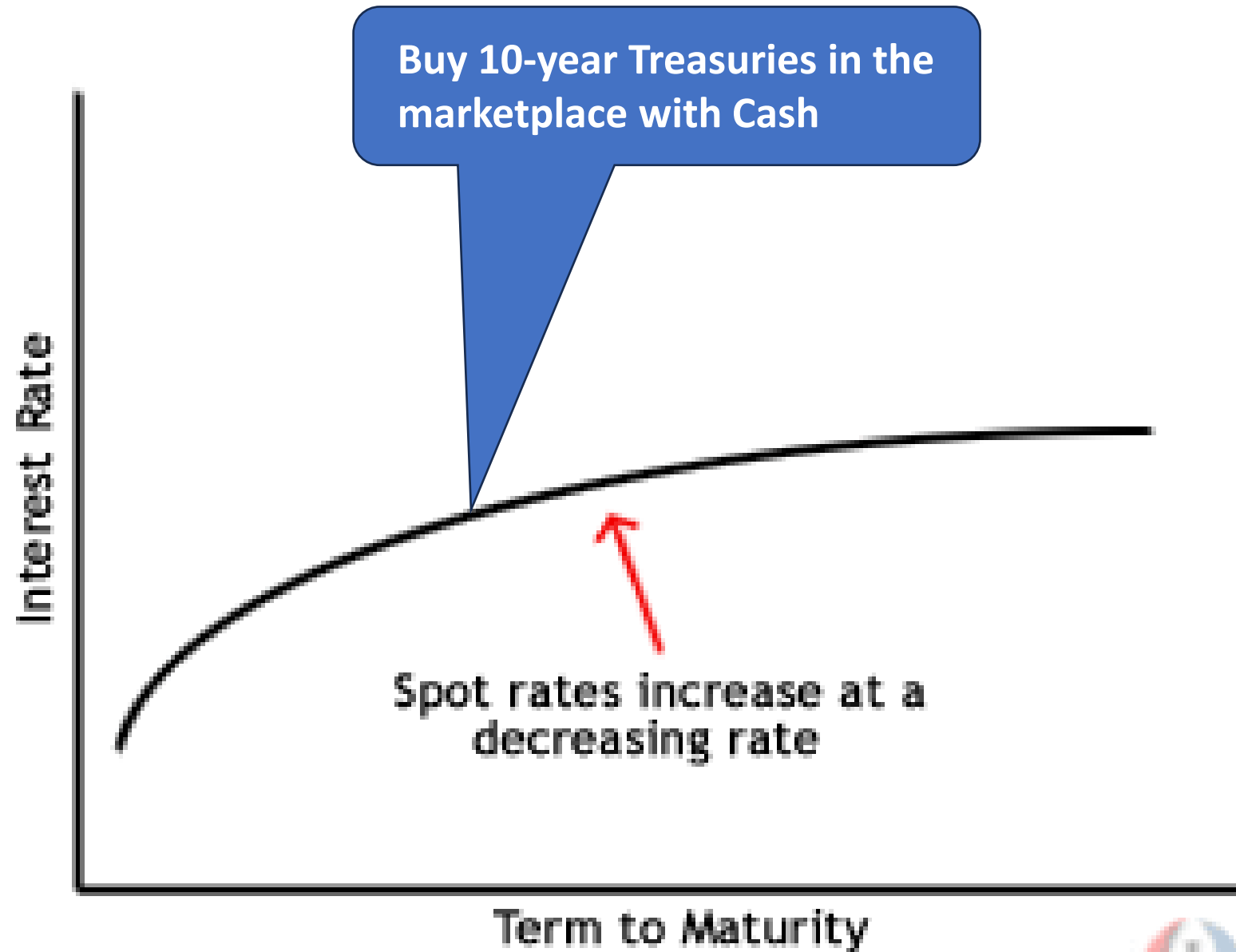
Attempting to twist the term structure of interest rates

- Also sometimes called “Quantitative Easing”
- What is this?
 - Desire to push up (or down) the interest rate at a very specific point on the term structure curve
 - NO the Fed can’t move more than that they’re way way too small
- How do they do this?
 - For example
 - Trade “cash” for “10-year US Treasury bonds” in the marketplace



Copyright 2003 - Investopedia.com





Doing so will drive the yield on 10-year Treasuries down and leave the “money supply” unchanged

- Lending money for a couple of hours
- Attempting to twist the term structure of interest rates
- Expanding the money supply

Expanding the money supply

- **Weak form**

- Attempt to manage the slow gradual growth of the money supply
- Predominantly pursued by controlling how much banks can lend and how easily
- For Example
 - Bank reserve requirement
 - Bank capital requirements

- **Strong form**

- Monetize the nation's debt
- For Example
 - The U.S. Treasury issues brand new Treasury bonds
 - The Fed then buys those bonds directly from the Treasury using cash
 - This results in an immediate expansion of the money supply
- This is what happened in Germany (Weimer Republic) from 1918-1933

Bottom line

- **Because**

- Journalists make it sound like they do
- Some financial advisors . . . speak the same way
- Our own investment industry . . . burns gigantic resources talking about what the Fed will or won't do next

- **This hurts our clients**

- Because they can only draw the worst possible conclusion
- i.e., that the Fed sets the level of interest rates

- **Misleading clients, encouraging them to believe in falsehoods . . . hurts everyone**

- **The Fed**

- Sets overnight lending rates
- This anchors one end of the interest rate curve
- Has no control over the curve
- Controls the growth rate of the money supply by setting bank rules

- **Exceptions**

- Almost none
- Yes, the Fed can very temporarily attempt to interfere with interest rates at one point on the interest rate curve . . . but only modestly and only temporarily

For more information contact



Jeff Megar, CFA
Email jeff.megar@julexcapital.com
Office 781-772-1378



Liam Flaherty
Email liam.flaherty@julexcapital.com
Office 781-489-5398

AssetMark - TAA, how does it perform when the S&P is in a bull market (and in a bear market)

Friday

August 11th

11:00 a.m. EASTERN

All data and statistics were provided by Global Financial Data, Inc. and NDR, Inc. (unless otherwise indicated in the exhibit)

This information in this presentation is for the purpose of information exchange. This is not a solicitation or offer to buy or sell any security. You must do your own due diligence and consult a professional investment advisor before making any investment decisions. The use of a proprietary technique, model or algorithm does not guarantee any specific or profitable results. Past performance is not indicative of future returns. The performance data presented are gross returns, unless otherwise noted.

The risk of loss in trading securities can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. All information posted is believed to come from reliable sources. We do not warrant the accuracy or completeness of information made available and therefore will not be liable for any losses incurred.

Some part of the investment performance shown is HYPOTHETICAL. It is based on the back tests of historical data. Hypothetical performance results have many inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any particular trading program.

One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the presentation of hypothetical performance results and all of which can adversely affect actual trading results.

The composition of a benchmark index may not reflect the manner in which a Julex portfolio is constructed in relation to expected or achieved returns, investment holdings, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility, or tracking error targets, all of which are subject to change over time.

No representation or warranty is made to the reasonableness of the assumptions made or that all assumptions used to construct the performance provided have been stated or fully considered.