Registered Investment Advisor Firm

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Who's That Yellen?

It's official, economist **Janet Louise Yellen** is the new Chair of the Board of Governors of the Federal Reserve System, and is the first woman to ever hold that position. Prior to her appointment, she served as the Vice Chair from 2010 to 2014. From all indications, Chair Yellen will continue the monetary policies put in place by her predecessor Ben Bernanke. Before being the Vice Chair, she was the President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, Chair of the White House Council of Economic Advisers under President Bill Clinton, and Professor Emerita at the University of California, Berkeley, Haas School of Business.

The monetary policies of the United States over the past five years have been one of "financial repression" in which government regulations, laws, and other non-market restrictions prevent the financial intermediaries of an economy from functioning at their full capacity.

Financial Repression

The actions over the past several years by the Federal Reserve have brought about "financial repression." Financial repression refers to a set of governmental policies that keep real interest rates low or negative and regulate or manipulate a "captive audience" (i.e. banks) into investing in government debt. This results in cheap funding and will be a prime tool used by governments in highly indebted and developed market economies to improve their balance sheets over the coming decades.

Typically this is accomplished through policies that cause: interest-rate ceilings; liquidity ratio requirements; high bank reserve requirements; capital controls; restrictions on market entry into the financial sector; credit ceilings or restrictions on directions of credit allocation; and government ownership or domination of banks.

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Economists have commonly argued that financial repression prevents the efficient allocation of capital and thereby impairs economic growth.

We should all be familiar with the effects of financial repression by now. For example compare the declining amount of interest income coming out of your savings account to the rising costs you pay for groceries, gasoline, or college tuition.

It has been nearly five years since the short term U.S. Treasury note hit effectively zero percent, resulting in negative real interest rates. These policies tend to discourage both saving and investment because the rates of return are lower than what could be obtained in a competitive market.

The main reason for the government to implement financially repressive policies is to control fiscal resources. By having a direct control over the financial system, the government can funnel funds to itself without going through legislative procedures and it's much cheaper than if the government had to resort to open market financing.

Some governments require banks to meet high rates of the reserve ratios, just like the U.S., and use the reserves as a method to generate revenues. Because reserves earn no interest, reserve requirements function as an implicit tax on banks and also restrict banks from allocating a certain portion of their portfolios to productive investments and loans. This restriction reduces the velocity of money which in turn keeps inflation in check.

One of the greatest impacts of financial repression is the damage it does to the savers and the retired. By keeping rates artificially low, savers are unable to earn meaningful rates of return on savings and bond performance may not produce a positive real rate of return when adjusted for inflation.

Additionally, sizeable Quantitative Easing (QE) strategies keep rates low on longer bonds. These QE programs have not proven to be a temporary fix to a short-term liquidity problem. At the same time, the massive expansion of central banks' balance sheets have raised inflationary expectations.

Financial repression requires a "captive audience" in order to succeed and it requires convincing that captive audience of buyers to hold government debt. In the U.S., this is being accomplished through the banks with reserve requirements and through pension funds.

Investors typically demand a positive real rate of return if they are to save rather than consume, but even nominal savings rates (before inflation) are set at rates below targeted inflation rates.

Because of this, consuming today is generally more attractive than deferred gratification through saving. If that real rate of return (after inflation) is high, people are motivated to save. If that real rate is low, they have stronger incentives to spend, and as it moves into negative territory, you are actually penalized for

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saving as your savings will have a lower purchasing power in the future.
In a normal economic environment, negative real interest rates would generate stronger present-day demand by reducing savings and increasing borrowing. GDP growth would rise and unemployment would fall.

But of course, we're not in "normal economic" times or in standard business cycle coming out of a recession. Instead we find ourselves in a debt overhang economy with weak demand pushed or at least aggravated by deleveraging.

The "Catch 22" is not weak demand, but rather high debt levels which can only be remedied by increased savings. Unfortunately our personal financial decisions are largely interest-rate insensitive.

The economic meaning of debt is a vehicle to transfer consumption or economic activity from the future to the present. Much of the developed world has become addicted to debt and debt-financed consumption. Therefore financial repression is the pragmatic solution to our debt addiction.

In this environment, the three principal asset classes of cash, bonds and equities (stocks) can be ranked in that order of least favorable to the most favorable. Financial repression discourages savings and artificially repressing interest rates in an already low rate environment leaves few choices beyond equities.

The lifespan of financial repression will probably be measured in decades, not years. Interest rates will probably not rise anytime soon, but remain at or below inflation for many years. Unemployment and under-employment will remain elevated and a large percentage of jobs may be lost forever due to advances in technology and productivity.

These forces have been building up over the course of several decades and it will take a fair amount of time to work off the excesses.

The bottom-line is financial repression punishes savers over time. It would appear that the policies in place will stay in place for an extended period of time, well beyond original projections (originally being 2014). As a result, the excess liquidity will find a home and it would be reasonable to expect that for at least the remainder of 2014, bonds should outperform cash and equities should outperform bonds. NOT A PREDICTION, just an observation on analysis.

As you can see these issues can be confusing and complex and if you are concerned or have any questions, be sure to ask your adviser.

Davis Investment Group

Davis Investment Group is a fee-based Registered Investment Advisor firm servicing the needs of clients across the United States. Davis Investment Group custodies all client assets at Charles Schwab & Co. Davis Investment Group's home office is located at 714 Marin Street, Suite #C, Vallejo, CA 94590. The telephone number is (707) 648-2024.

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If have questions or would like further information on this month's topics, please contact me directly at (925) 360-6819 or through email at: Bud@DavisInvestmentGroup.biz

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