



Are You Fed Up With The Fed?

By Meri Anne Beck-Woods

On November 10, 2004, the Federal Reserve again raised its target for the Federal Funds rate, the benchmark U.S. interest rate a quarter point to 2%. From their latest comments, the Federal Reserve Governors echo the point that monetary policy in the United States “remains accommodative” and the fed funds rate still seems low relative to inflation and the economy. As of November 10, the level of the primary discount rate was 3% and the prime lending rate charged by most banks was 5%.

The comments of most Federal Reserve Governors indicate that the fed funds rate will continue to go up perhaps as soon as December 14th when the Federal Reserve Open Market Committee meets again. Since late June the Fed funds rate has gone up 100 basis points, or one per cent at the same time energy prices have soared and inflation has been less benign.

While the Fed governors have said they will raise interest rates at a “measured pace” one cannot help but think of 1994 when the Fed funds rate was raised five times from 3.25% on 2/04/1994 to 4.75% on 8/16/1994 devastating the bond market and in five out of six meetings the Fed was tightening in their bias. That period also marked a period of inter-meeting increases in the Federal Funds Rate.

So far this activity has dampened home sales as sales of existing homes and condominiums dropped 1.8% from the second quarter and prices which had risen 8.9% in the prior quarter were only up 7.7%, putting the real estate market on notice that times may be harder in the future.

The Federal Reserve was founded in 1913 and established a central banking system long used in Europe to pool bank reserves and create a lender of last resort. In 1920 the fear of inflation caused the Fed to raise interest rates on 12 month treasury certificates to 7.75%. This caused a drop in the value of corporate bonds by 11%, pretty big for a so called less risky asset. Will they do it again? I hope not. Productivity is still strong and even though inflation is back it is not out of hand.

What do you do in a rising interest rate market? There is the “buy and hold” strategy, ignoring the Federal Reserve’s ups and downs and the subsequent drop in the price of your bonds and collecting your coupons and principal at maturity. The market timers are a different breed and try to anticipate the direction and timing of interest rates, a dicey job at best. It is better to have higher quality bonds when interest rates are rising as the spread or difference between different sectors of the bond market may not justify lower credit quality. Consider callable bonds as the likelihood of a call is diminished due to rising interest rates and a more expensive cost of money.

If rates are rising rapidly, you will get more out of your money market funds as rates go up, and if your bond holdings are short to intermediate term, your price fluctuations will be less than if you had long term bonds. In 1987 when the stock market dropped over 500 points interest rates on 7 year bonds soared to almost 10%. That made them very competitive with the long term return on stocks and if non-callable a good buy.

Allan Greenspan has been chairman of the Federal Reserve since 1988. Paul Volcker was chairman from 1979 to 1987, and the two are completely different characters. Where Greenspan will make public comments that can dash the hopes of equity and bond investors alike, Volcker was closed-mouthed and never entirely comfortable with the press. You would never hear him speak of irrational exuberance to deliberately affect the market.

When Greenspan appears before congressional committees, which are open to the public, he may choose politely to decline to answer committee questions on his intent or use dense technical language to confuse the public and the panel. Some points you should watch for in Fed stories are if the Fed says it sees the economy growing faster, inflationary pressures increasing or the money supply expanding at a faster clip, it may be preparing to push interest rates higher. Also with announcements of low unemployment levels or increasing labor costs.

On the other hand, if the Fed is concerned about economic weakness and high unemployment and confident that inflation and labor costs are well contained, the central bank may push interest rates lower.

In the usual case of conflicting or confusing statements, you must weigh the emphasis given for each statement. Tarot cards or a Ouija board might help. In any case a government official has a lot of power in this country and perhaps it is time we reigned that power in a little bit. Greenspan is well past the age of retirement and who knows who the next Federal Reserve Chairman will be.

If you have high coupon bonds that are of good credit quality you might lose the premium or high price but you will still collect the coupon, and if they are government bonds presumably get you money back at maturity. If you have lower quality bonds be prepared for some significant price volatility and make sure you don't need the money before the bonds mature.

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