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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

If I didn't already have gray hair, mostly white actually, the events of the last several months would have caused that train to leave the station. I have been doing this line of work for a pretty long time, and there have been few times as confounding as these have been. Nothing much has changed in regards to overall economic activity and broad macroeconomic forecasts. However, the markets have been all over the place; hanging, almost solely, on the words of Federal Reserve officials, and other bureaucrats, with billions, if not trillions, of dollars at stake.

While this has always been the case to some degree, let's just say it has been in overdrive recently. The reason for this is simple: is the Federal Reserve seeing something the rest of us aren't? Or has it become divorced from reality?

The answer is probably neither. After a few cocktails, I doubt any Fed governor would tell you they believe the US economy is in danger of overheating or is functioning above capacity. They would probably even admit they wouldn't even be thinking about a rate hike if the overnight lending target were at 2%, perhaps even less than that.

All of this turmoil has to do with whether the Fed thinks the economy is sound enough to weather a few rate hikes which would give Yellen, et al, some breathing room for future policy decisions. In essence, the Fed wants to raise rates so it has the ability to cut them should the need arise at some point out in the ether.

So, can the economy handle slightly higher interest rates? You know, the answer is more than likely, but there is no need to get carried away with it. Why? Because people's debt service will increase more rapidly than the amount of interest investors will receive. This will suck money out the C (consumer) variable of the GDP equation and end up as additional capital on bank and credit card company balance sheets. *Which isn't necessarily a bad thing, as more bank capital is always better than less bank capital.*

However, this should, probably will, have a compressing effect on the economy because "personal consumption expenditures" are currently 68.4% of the GDP equation. If folks are paying the bank and other creditors more money, they will have less to spend on goods & services. Oh, I can slice & dice the data and do all sorts of mental gymnastics, but that is about it in the short-term. Consumer expenditures WILL slow from the current rate of growth unless there is a corresponding increase in wages (and median household income) which is as great or greater than the increase in the debt service. As I type there is no reason to think there would be because corporate debt service to the bank will be going up as well….and that will be more than the increase in consumer debt service.

Even so, over time and all things being equal, I am a bigger fan of higher interest rates moving forward than ever lower interest rates. While that might sound blasphemous, the reason is simple: persistently low interest rates, artificially set or anchored by third parties (meaning central banks), skew the IRR (internal rate of return) or ERR (economic rate of return) assumptions businesses and investors use during the capital budgeting and/or investment decision making process.

If not skew, they send out false signals about the actual risk and/or projected return associated with individual projects or investments. This could lead to the misallocation of precious resources, causing excess capacity in industries that don't need it and a lack of necessary capacity in industries that

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do. While this misallocation might only be a short-term phenomenon until interest rates approach what would be the true market clearing equilibrium but for third parties' interference, there will be economic pain when the true economic rates of return and actual risks become more readily apparent.

Trust me, this can get nerdy in a hurry, if it hasn't already. However, think of yourself as a consumer: have you ever purchased something in a store on impulse simply because the price was low, without questioning the product's true utility or your actual need? I would be willing to bet a plug nickel I am not alone here.

Some years ago, I was in the CVS the week after Christmas, although I have forgotten my initial reason to go there. Regardless, my receipt for whatever it was I bought had any number of manufacturers' coupons and in store cash credits. Ordinarily, I don't pay too much attention to these things, and give them to my wife. However, on this day, there was a $10 in store credit coupon which caught my eye. Also catching my eye was the store was selling its remaining Christmas decorations at an 80% discount. Hmm.

Well, there just happened to be a 3-foot, lifelike Santa Claus figurine type thing dressed in old-fashioned clothing along my path to the door. Again, hmm. I looked at it, and the original retail price was $49.99. So, 80% off basically $50 is, drum roll please, $10. A ha. So, I picked him up, went back to the cash register, and gave the her my coupon and $1 for the applicable sales tax. Incredulous, she asked me: "did you just buy that Santa for nothing?" I said: "well, yeah, but I still had to pay the tax." It would be an understatement to say I thought myself rather clever.

Now, I wanted to keep this a surprise; so, I hid Santa behind something in the garage, and didn't bring him out until the following year. One night, after everyone had gone to sleep, I retrieved him, and put him at the top of the stairs. It was to be the "elf's" present to the kids, who were much younger back then. Again, I thought myself rather clever.

The next morning, I heard some blood-curdling screams followed by sobbing, and I ran up to see what was the problem. I will cut to the quick, and tell you Santa absolutely scared the living wits out of my kids. At the time, they really weren't that much taller than the thing, which I hadn't taken into account...at all. So, far from being fun, my surprise, which I had waited around 11 months to do, was actually rather frightening, particularly to elementary school aged children just after they had awakened.

The commotion that morning wiped the proverbial sleep out of my eyes, and I finally saw my Santa, my big surprise, for what it really was: kind of creepy. So much so, my wife asked: "Where in the [world] did you get that thing? But it up or throw it out. I don't care, just get it out of here." So, back Santa went, behind whatever it was, and stayed there for the next, I don't know, 5+ years….only until just recently.

Now, I wouldn't have paid a dime more than the $1 I paid in tax for the thing. Seriously. I mean, even at a price of $0, it wasn't worth the money. What a horrible purchase! However, I bought it because the CVS had set the price below the MSRP, and essential gave me the money to buy the dern thing! Does this sound familiar to recent US monetary policy? I think it does.

Since interest rates are nothing more than the price of money, would it or does it make sense for the Federal Reserve to raise the overnight lending target? Unfortunately, the answer is: it depends on what the true price of money is. If the true cost of overnight money between banks is, say, 0.75%, the Fed could raise the overnight rate to that level with

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only a relatively minor negative impact on the economy. However, if the true cost of money is 0.25%, any rate increase will have a more pronounced effect. Basically, the Fed can raise it to the market clearing rate, and the economy will only feel the detrimental impact of the increase in debt service costs. If it gets too aggressive, it runs the risk of drying up credit in the economy, as banks flock to the better deal at the Fed, as opposed to lending it out in the private sector.

But what about all those projects getting done because the price of money is/was artificially low? Well, if that is the only reason why they got done, they probably didn't have much true intrinsic value or economic worth anyhow, kind of like my Santa Claus. They are the economic equivalent of breaking a window, which requires a glazier, etc., even if the end result is the same as it was previously. If not that, perhaps putting up a McDonald's in Loving County, Texas (population 82), might be a more apt analogy.

Now, there are those that would counter: "the Fed doesn't actually control any interest rates; it only influences the rate which banks lend overnight to one another by setting a target." That is a completely accurate statement, and I mean 100%. However, if I am in a fight with someone my same age, size, and strength, and Hulk Hogan arrives to tell us to shake hands or else, would you care to guess what I am going to do? Do you think the Hulkster would have any influence in my little scrap? Of course he would.

This then leads to the brass tacks: the markets and the economy are on pins & needles because of the Federal Reserve, a body comprised of academics outside of the private sector, which has the ability to artificially influence the price of money in the United States, which has the potential to misallocate resources or stifle credit should they/it not indirectly set the price of money within a reasonable variance of the true market equilibrium clearing price, is potentially going to raise its influence target.

I just reread that paragraph, and can't believe it. Oh no, there is nothing wrong with it, other than being wordy and a run-on, it is just that I actually wrote it. What in the heck have I become? I feel like Eugene from the movie "Grease." You know, that guy in the picture.

So much so, I am going to close today with the following: the economy can probably handle a 0.25% rate hike or two, maybe even a couple more. However, with the amount of excess reserves banks already maintain at the Fed, overnight money wouldn't be terribly expensive even if the Fed weren't involved in influencing its price. Sure, it would probably be a little higher than it is currently, but not by much more than the historical spread between inflation and the Fed Funds target which has been, drum roll please, right at 1.00% over the last 30 years….on average.

With the 12-month Consumer Price Index currently at 0.2%, that upper limit to the Fed, at this juncture, is 4 0.25% rate hikes, or 1.00%, to 1.25%. This will compress, but not depress, overall economic activity, add to bank capital, and reduce the misallocation of resources moving forward. All in all, not the most fun you can have, but not the end of the world either….far from it.

Perhaps the markets have come to the same realization today, as they are up significantly as I type. While the given excuse is a robust jobs report, I have actually overanalyzed this morning's Employment Situation report and decided to right on this topic instead. Do you catch my drift?