THE DANA VIEWPOINT

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The Fed's Conundrums

Will Rogers was asked once (or twice) why he made fun of Congress. He said simply, "because they make it so easy". The same may be said of the Federal Reserve today, but they get more sympathy as they can't get it just right. And much of it is not totally their fault. Take the March jobs report for example. Though the headline unemployment number rose to 5.0% from 4.9% last month, the employee participation rate also ticked up to 63% marking the highest level since March 2014, and up from 62.2% a year ago. So the conundrum is that more people are now actively looking for work which means they are now considered unemployed where in the past anyone who was not working and not looking for work was not considered unemployed. So a rising employee participation rate is positive, but it is resulting in a rising unemployment rate. Maybe it's just a conundrum that the Fed will have to live with. Regardless of the statistical shenanigans, as long as the number of fully employed in the workforce continues to grow, we must be on the right path.

The specter of negative interest rates is also providing a conundrum for the Fed. While Japan and other nations are actively pushing for negative interest rates as a monetary solution to promote economic growth, the Fed does not seem to be consciously promoting this approach, but it is happening anyway. Recently the 10 year Treasury bond had a yield of 1.7%. On the other hand, inflation is running at about 1.8%. Adjusting for inflation investors are losing money. The conundrum of course is the Fed wanting to keep interest rates low while pushing for a higher rate of inflation (at least 2%). Those two approaches cannot co-exist. The result so far has been a continued flow of investors' money into common stocks. Hence, an extension of the bull market that began in March 2009. This may be a conscious effort by the Fed to continue former Fed chairman Ben Bernanke's stated effort to push investors into common stocks and create a wealth effect. The stock market goes up, investors feel rich, they spend more money, that creates jobs and the economy improves. Has it worked? We are entering the seventh year of a bull market in common stocks and while the significantly damaged housing market and auto industry have experienced strong recoveries, the economy is averaging only 2% annual growth since the end of the recession, making this recovery much slower than previous recoveries - although still much better than the rest of the free world. Unfortunately the strong financial market recovery has added to wealth dispersion as those with significant assets have been greater beneficiaries.

(CONTINUED ON REVERSE SIDE)

Not all sectors of our economy benefit from low interest rates. Financial institutions, which are central to our economic systems, are a big loser when interest rates are low. Financial institutions profit on the spread between the rate they pay for funds and the rate they lend funds. Today that spread is very narrow. Many banks will be reporting earnings for the first quarter this week. Those earnings are likely to be lower than last year's first quarter. Just another dilemma for the Fed when they are considering raising interest rates. It's not an easy job for the Fed, but when it comes to trying to manage a $19 trillion economy, less is more. The economy will make its own adjustments and has done so for decades.

So you hear the sound of gnashing of teeth? It must be tax time. It just gets more complicated every year with new deductions and the elimination of old ones. We do need some kind of tax reform and every year Congress talks about it and every year they do nothing. It could be worse though. FDR raised the maximum income tax rates to 91%. It's hard to imagine giving the government 91% of your earnings and of course many wealthy people found ways around it. Fortunately Kennedy, Reagan and others got it down to 39%, which is still one of the highest rates in the free world. While taxes are necessary for the government to provide essential services and benefits, it is debatable whether giving them more will improve the economy. Taxpayers allowed Congress to borrow $1 trillion in 2009 to stimulate the economy and nobody seems to know where that money went. Corporations of course have come up with their own plan to avoid taxes. It's called an inversion where a corporation buys or is bought by a foreign company and then moves their headquarters to that foreign country that has a lower corporate tax rate. While very political, the scheme continued until Allergan, an Irish company wanted to merge with Pfizer, an American company and move Pfizer's headquarters to Ireland, thereby paying Ireland's 12.5% tax rate instead of the US's 35% tax rate. With the Obama Administration frustrated with past inversions, the Treasury Department recently wrote some new rules effectively blocking the merger – for now.

On the personal income tax side it has just been discovered that many wealthy Americans have been placing money in banks in Panama, which has a secrecy code like Switzerland used to have. They then have a law firm set up an offshore shell company in which to place (hide) the money and avoid paying US taxes. These cloak and dagger games will continue until our tax code is simplified. In the meantime the government is losing millions (probably billions) of dollars of revenue. It's always the middle class that ends up with the bill for these scams.

Random Thought for April 2016: Happy Birthday William Shakespeare – 400 years old April 23rd

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