July 15th, 2013

Jawboning

Author: Benjamin Struck

President

Economic Summary → 3

Strategic Allocation → 5

Tactical Allocation → 6

Last week stocks recovered all of the losses from the last month. Bonds and commodities recovered somewhat, but remain much lower than earlier in the year. The rise in stocks was largely attributed to Fed jawboning. Jawboning is the practice of using verbal communication to elicit a specific reaction from the markets. Jawboning is also sometimes referred to as "talking the markets up" or "talking down the markets". This week we will look at some of the different ways that the Fed can affect the economy, and how jawboning has been successful so far.

S&P 500 Index		
↑	40.05	2.44%
Dow Jones Industrial Average		
↑	254.5	1.67%
NASDAQ Composite		
↑	105.62	3.02%

Boning Up

There are a number of tools that the Fed can use to change interest rates and the money supply. The Fed is able to adjust interest rates, manage bank reserves, and change the value of the dollar relative to other foreign currencies.

The most direct but least common tool that the Fed uses is the discount rate. The discount rate is the rate that the Fed lends directly to banks. The Fed is referred to as the "lender of last resort" because the discount rate is currently 0.50% higher than the rate that banks can borrow from in the open money markets. Banks will typically only seek the discount rate once they have exhausted all other options, because it makes them look weak and it opens their operations to additional Fed scrutiny.

The more common rate that banks use to obtain fund is the federal funds rate. The federal funds rate is the rate that banks lend to one another in the open money markets. The Fed controls the federal funds rate indirectly by managing the supply and demand of bank reserves. The fed uses the reserve requirement ratio to mandate the required level of bank reserves that must be held. Currently large banks must hold at least 10% of their funds in reserve to be in compliance with the Fed's required reserve ratio. If a bank needs to borrow money on a short term basis to maintain this 10% ratio it can borrow overnight from a bank who's reserves are higher than 10%. If most banks have reserves higher than 10% that means that supply is high and the federal funds rate should fall to adjust to this.

The fed can affect the supply of reserves via another tool called open market operations. This is the most commonly used tool and it is how the fed achieves quantitative easing. If the fed wishes to lower interest rates they can buy or sell treasury bonds and mortgage backed securities in the open market from the banks. If they buy these securities they will credit the account of the bank and thus increase the bank's reserves and in turn lowers the fed funds rate. Rates have been close to zero since the fed has been consistently buying treasuries and mortgage backed securities in the open market since 2008. Open Market operations are conducted by the Federal Reserve Bank of New York and you can find their schedule here.

When a bank holds more than the required 10% in reserves this is known as excess reserves. I wrote about excess reserves in a newsletter several months ago, which you can read here. I read an interesting passage from a textbook from 2009 which stated that, "Individual banks whose reserves rise

will generally make new loans, equal to the new deposit less required reserves, because loans earn interest while reserves do not."[1] This assertion only made sense before 2008 when the fed began paying interest to banks that held more than the reserve requirement ratio. Despite the huge increases in the fed balance sheet, Bernanke has remarked that inflation has remained very low. This is because of interest on excess reserves paid by the fed to the banks reduces lending. Normally the banks would lend the money into the economy to earn interest on their excess reserves, but the opportunity cost for lending is now 0.25% higher than it was prior to 2008. Paying interest on excess reserves is a debatable topic, if you are interested in learning more I recommend reading this paper.

There are other ways that the fed can affect the money supply and the value of the dollar. They can manipulate the value of the dollar relative to other currencies by buying or selling other countries currencies. The stated goal of currency operations is to prevent disorderly currency movements and currency speculation. The fed also uses repurchase agreements or repos and reverse repos to make temporary changes to the system. A repo is when the fed borrows treasury securities from a counterparty for a short time period and agrees to sell them back at a higher price. A reverse repo is simply the opposite, the fed will lend out securities and agrees to buy them back at a higher price in a short period of time.

Accidental Jawboning

As we mentioned earlier, the fed has used jawboning as a technique to guide the markets to a desired result. Sometimes the fed mistakenly jawbones the market. One famous example was in 1996 when former Fed Chairman Alan Greenspan spoke about irrational exuberance and wondered if there were speculative bubble forming in stocks. Even though there were no announced changes in policy, the market immediately began selling off as investors worried that the fed may try to raise interest rates to cool this speculative bubble.

Last month when Ben Bernanke supposedly spoke about tapering, he did not actually announce any changes to policy. He said that he would slow asset purchases if the economy recovered and increase asset purchases if unemployment remained low and inflation was controlled. Bernanke also stated that he was seeing improvement in the economy. This led the market to believe that the Fed would begin tapering soon; interest rates on treasuries rose and the market crashed. I believe that this was unintentional jawboning, because, since that speech, many fed officials have made public statements trying to talk the market higher.

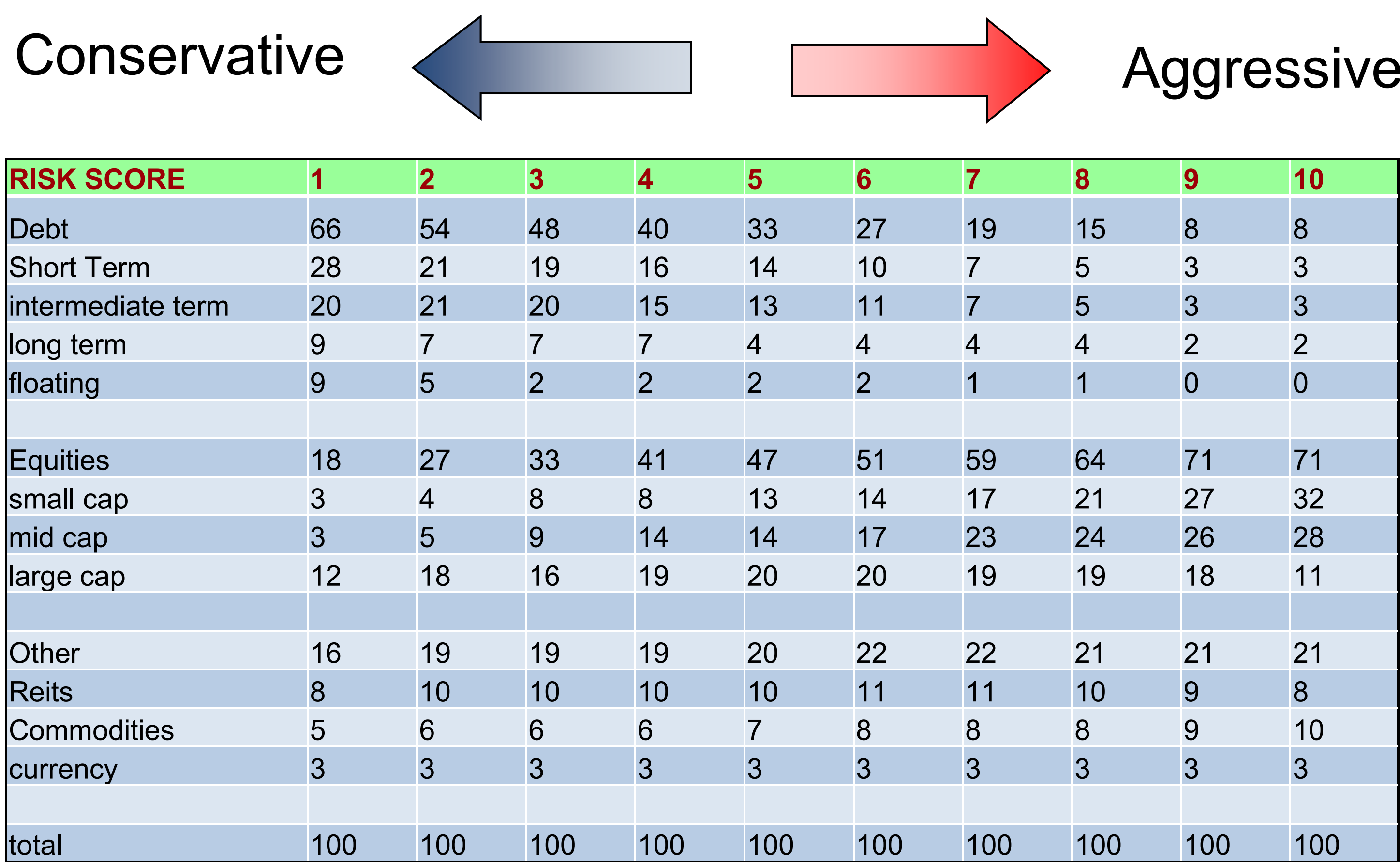
Just last week in a speech about the history of monetary policy. Bernanke said that inflation remained low and that he foresees a prolonged period of accommodative monetary policy. This led the market to rally significantly the next day.

Conclusion

Jawboning can be used to make temporary changes and effectively control markets without doing anything at all. It can be used to guide future expectations towards monetary policy so that market participants are not shocked when they actually happen. However, if the fed is not careful it can elicit the opposite reaction that it intended or even incite panic.

1 Fabozi, Modigliani, and Jones, *Foundations of Financial Markets and institutions* (Boston: 2010), p. 66.

Strategic Allocation



RISK SCORE	1	2	3	4	5	6	7	8	9	10
Debt	66	54	48	40	33	27	19	15	8	8
Short Term	28	21	19	16	14	10	7	5	3	3
intermediate term	20	21	20	15	13	11	7	5	3	3
long term	9	7	7	7	4	4	4	4	2	2
floating	9	5	2	2	2	2	1	1	0	0
Equities	18	27	33	41	47	51	59	64	71	71
small cap	3	4	8	8	13	14	17	21	27	32
mid cap	3	5	9	14	14	17	23	24	26	28
large cap	12	18	16	19	20	20	19	19	18	11
Other	16	19	19	19	20	22	22	21	21	21
Reits	8	10	10	10	10	11	11	10	9	8
Commodities	5	6	6	6	7	8	8	8	9	10
currency	3	3	3	3	3	3	3	3	3	3
total	100	100	100	100	100	100	100	100	100	100

The Strategic allocation represents what should be the long term average of a portfolio. That is, the average allocation of the portfolio should adhere to these risk allocations. Different asset classes will outperform during different market conditions. This allocation will change slowly as new information comes to light that will affect the long term performance of certain asset classes. We expect that portfolios that are more aggressive will outperform conservative portfolios over a longer period of time, but will experience a greater amount of volatility.

Neutral short term debt, particularly for more conservative clients. This sector should reduce interest rate risk as well as market risk in the portfolio.

Neutral intermediate term debt

Overweight Long Term Debt, this asset class has been oversold as a result of market expectations of Fed tightening, we are slowly purchasing more long dated treasuries and TIPS at the higher yields.

Overweight on floating rate debt, we are expecting slow and steady appreciation on floating rate notes.

Overweight Small Capitalization Stocks, we are recommending smaller companies with strong balance sheets and little need for short term debt financing.

Neutral Mid-Cap Stocks, we apply the same logic to this asset class as to small cap stocks.

Underweight Large Cap Stocks, We are more selective with large cap stocks, and will try to avoid those companies with a larger exposure to the Chinese economy.

Neutral REITs, we will start looking to slowly increase REIT holdings now that selling has begun.

Overweight Commodities, we believe that we are now in a period of deflation, and that the selloff in commodities is largely tied to China. This selloff is likely overdone especially with respect to precious metals. We are bearish on oil prices.

Currency - We are underweight the Euro. We continue to recommend protecting any exposure to the yen. We are holding higher levels of U.S. dollars, but will begin reinvesting those dollars on future weakness.