

'No direction home' for Federal Reserve

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Robert Smith

I thought it apropos to use the line from Bob Dylan's famous song "Like a Rolling Stone" to describe the Fed's current predicament.

After nearly five years of unprecedented monetary stimulus (QE1, QE2, QE3 and now QE4) the never robust economic "recovery" appears to be slowing. Housing fervor is cooling, job creation remains anemic and consumer confidence is eroding.

It should be apparent to all that the economy can't stand on its own. As I mentioned in my last column, it still needs monetary crutches. Truly, the Fed has "no direction home."

This becomes patently obvious with the nomination of Janet Yellen as Ben Bernanke's successor. Acolyte of Keynesian economics, Yellen is strong a word to use when describing Yellen's relationship with the current Fed chairman. So, folks who were once big fans of Bernanke's Fed the past seven and a half years probably will like a Yellen-led central bank even less.

Like her current boss and mentor, Yellen is a Keynesian. Keynesian economics holds that private-sector decisions often lead to inefficient macroeconomic outcomes. Hence, it is the responsibility of that supremely efficient entity known as government (Obamacare, anyone?) to intervene in the economy to stimulate aggregate demand (total spending in the economy). This is particularly true during recessions. Hence, the controversial policy of "quantitative easing" (or QE), which the Fed has pursued since 2008.

However, by vastly increasing the money supply over the past five years, the Fed could very possibly be setting the stage for future inflation. In so doing, Bernanke and Yellen appear to be replaying the 1970s stagflation.

The last time around, it took Lyndon Johnson five years of spending on "The Great Society" and his "war on poverty" to stoke the inflationary fires. So far, we are right on script. Five years of quantitative easing has given us exactly the same results: a stagnant economy and high unemployment.

So far, these policies have not driven inflation higher, given the counterbalancing effects of weak loan demand and high unemployment. However, the day will come when loan demand returns, interest rates move higher and the specter of inflation returns.

This outcome may not be of immediate concern to you, but it begs the question of how asset classes perform in this type of environment. In the short run, stocks generally could do well based on more monetary easing. However, there is no proven connection between QE and economic growth, Yellen could just keep printing money indefinitely without getting the results she seeks. However, investors need to be alert to the real possibility that higher stock prices in a flat-line economy may simply be the new Fed-inspired bubble.

Inflation may be slow to arrive; however, when it does, it will increase quickly (as in the late '70s and early '80s) and be impossible to reverse without collapsing the economy. As before, this will result in a widespread loss of value for hard assets. Therefore, investors would be well advised to consider precious metals, energy, land, and other natural resources before the next big wave pushes their prices substantially higher.

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1311