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The Coronavirus and the Economy – Why the Fed Matters

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THE STOCK MARKET IS NOT THE "ECONOMY"

The trading of stock in public companies is an important part of the U.S. economy.

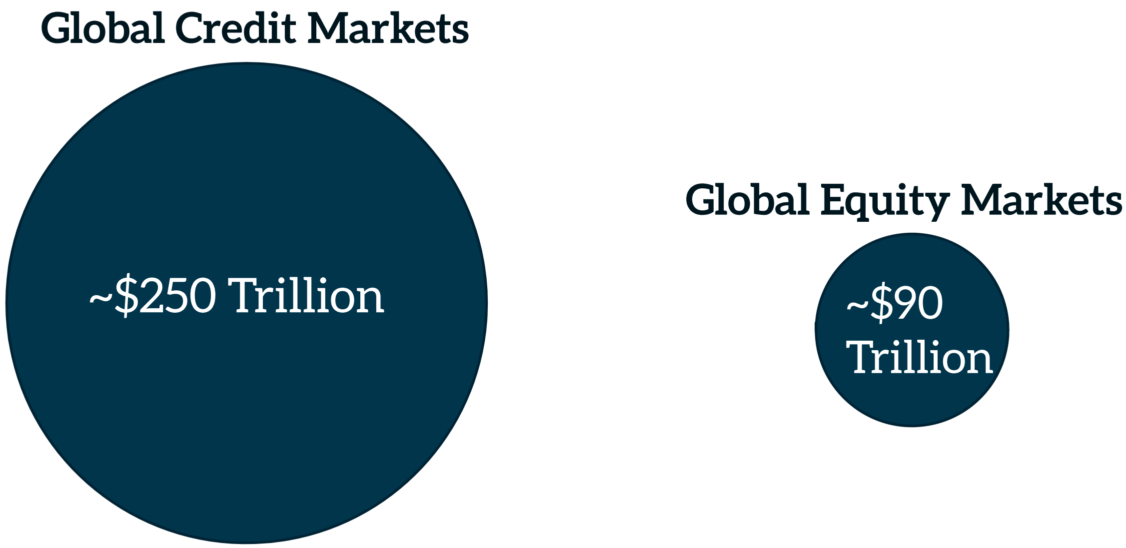
- Stocks are a type of security that represent ownership interest in a company.
- Stock trading allows businesses to raise capital to pay off debt, launch new products and expand operations.
- For investors, stocks offer the chance to profit from gains in stock value as well as company dividend payments.
- Stock prices influence consumer and business confidence, which in turn affect the overall economy.
- The relationship also works the other way, in that economic conditions often impact stock markets.

The Credit Market

Domestic Equity	YTD
S&P 500	-20.0%
Dow Jones Industrial Average	-23.2%
NASDAQ	-14.2%
Russell 1000	-20.2%
Russell 2000	-30.6%
Russell 2500	-29.7%
International Equity	**YTD**
MSCI ACWI Ex US	-23.3%
MSCI EAFE	-22.7%
Emerging Markets	-23.6%
Fixed Income	**YTD**
Barclays Aggregate	3.1%
Barclays Universal	1.3%
S&P/LSTA Leveraged Loan	-13.0%
Barclays U.S. Corporate	-3.6%
Barclays High Yield Corporate	-12.7%

- A bond is a debt that the company or entity enters into with the investor that pays the investor interest on that debt.
- Interest payments stay the same for the life of the loan. You receive the principal at the end if the borrower doesn't default.
- A bond's value changes over time, which matters only if you want to sell it on the secondary market. Bond traders compare their returns, called the yield, to that of other bonds.
- Bonds are often lower risk relative to stocks due to how they have fixed coupons (or interest) rates on their loans.

The Credit Market



- The bond market is part of the credit market, with bank loans forming the other main component. The global credit market in aggregate is about 3 times the size of the global equity market.
- The Federal Reserve controls interest rates through its open market operations. When the Fed wants interest rates to fall, it buys U.S. Treasurys. That's the same as increasing demand for the nation's bonds, which makes their values rise. As with all bonds, when the value rises, interest rates fall.

Source: International Institute of Finance November 2019

DEPARTMENT OF THE TREASURY & THE FEDERAL RESERVE

What is the difference between the US Treasury and The Federal Reserve (“The Fed”), and how do they work together?

The U.S. government has a vested interest in the health and welfare of the country's economy. The Department of the Treasury works hand in hand with the Federal Reserve to maintain economic stability.

Key Takeaways:

- The U.S. Treasury is best known for printing money (literally) and offering economic advice to the President.
- The Federal Reserve is the U.S. central bank, ensuring that lenders and borrowers have access to credit and loans.
- The two work together to provide a stable U.S. economy and borrow money when the government needs to raise cash.
- The two are instrumental in fighting recessions and bailing out institutions when necessary.

PUTTING IT IN PERSPECTIVE

- Think of how a “gas powered engine” operates.
  - You need Oil and Gas: Oil to keep the gears moving, Gas to provide the spark!
- The economy is similar: The debt markets are an important part of the process.
  - Without a functioning credit market, the engine seizes – just like an engine with no oil.

THE U.S. TREASURY

- Established in 1789, the Department of the Treasury is the oldest of the two institutions.

- While it's perhaps best known for its role in collecting taxes and managing government revenue, its official mission is to:

  "serve the American people and strengthen national security by managing the U.S. government's finances effectively, promoting economic growth and stability, and ensuring the safety, soundness, and security of the U.S. and international financial systems."

THE FEDERAL RESERVE BANK

- Although the Fed is the central bank of the United States, it is not really a true government institution.
- The Fed is not funded by tax dollars, and its decisions do not have to be approved by the President or either house of Congress. The governing body within the Fed is the Board of Governors.
- The Fed influences macroeconomic variables such as inflation, unemployment, GDP, and interest rates by adjusting the supply and demand for base money.
- Because the Fed has a monopoly in the production of base money, it has an almost unlimited ability to influence its value, which is why Congress gave the Fed the duty of stabilizing the price level.
- After all, the price level is merely the inverse of the value of money. Controlling inflation means stabilizing the value of money.

INTEREST: THE PRICE OF MONEY

- One way the Fed accomplishes its goals is through the use of monetary policy.
- In simple terms, monetary policy is the manner by which the Fed controls the supply of money in the economy.
- The manipulations of the money supply affect interest rates, which in turn influence the economy and the financial system.
  - For example, throughout the year 2001, the Fed increased the money supply dramatically.
  - This increase in the money supply lowered the interest rates of 30-year Treasury bonds.
  - Mortgage rates are influenced by the rate of the 30-year Treasury. So, as the Treasury rates fell, so did interest rates on mortgages.
  - The result has been a boom in the housing market and the refinancing of many existing mortgages to take advantage of the lower rates.

INTEREST: THE PRICE OF MONEY

- It is important to have a basic understanding of what interest rates are and the influence they have on the overall economy.
- An interest rate is the price of money.
  - For example, the interest you pay on a loan or credit card is the price the lender charges you to use their money. The price of money, like any other good, is determined by supply and demand. The Fed influences interest rates by controlling the money supply.
- Sometimes it is difficult to understand how the supply of something can be such an important part of its price. In general, a good that is plentiful, such as loaves of bread, will be inexpensive. Goods that are scarce, like diamonds, are expensive.
- The same principle applies to the cost of most goods, including money. If money is plentiful, it becomes inexpensive as interest rates fall. If it is scarce, it is more expensive when interest rates increase.
- By changing the supply of money in circulation, the Fed changes the price of money.

THE FEDERAL OPEN MARKET COMMITTEE (FOMC)

- The Federal Open Market Committee (FOMC) is in charge of controlling the money supply. This committee is made up of the seven members of the Board of Governors and five Reserve Bank Presidents from around the nation.
- The Fed changes the price of money through the use of monetary policy. In simple terms, monetary policy is the manner by which the Fed controls the supply of money to the economy.

THE FEDERAL OPEN MARKET COMMITTEE (FOMC)

The FOMC controls the money supply in the following three ways:

- Buying and Selling Treasury and Federal agency securities on the open market. If the Fed feels that lower interest rates will benefit the economy, they will buy large amounts of Treasury Bills and other government securities. By purchasing these securities, the Fed injects large amounts of cash into the economy. They make money more plentiful. Just like most goods, when money becomes plentiful, it becomes less expensive. By contrast, if the Fed wants to increase interest rates, they sell large amounts of securities and the money that is paid by the buyers is taken out of circulation. Money becomes scarce and therefore, more expensive.
- Changing reserve requirements for banks. Banks are required to keep a percentage of their clients' deposits on reserve to facilitate orderly withdrawals. If the Fed increases the reserve requirement, it increases the amount of money kept out of circulation, which pushes interest rates higher. If the Fed decreases reserve requirements, rates tend to fall.
- Changing the Discount Rate. The Discount Rate is what the Fed charges banks that borrow directly from it. These are very short-term loans, usually overnight, meant to cover shortfalls in reserve requirements. The Fed sets this rate directly instead of through supply and demand. When banks need to borrow money to supplement their reserves, they will generally borrow from each other. Banks typically will only borrow directly from the Fed as a last resort.

THE FEDERAL OPEN MARKET COMMITTEE (FOMC)

- If economic growth is slow, the Fed would reduce interest rates by increasing the money supply to make more money available to businesses and consumers in the hope that it would stimulate faster growth. This is sometimes referred to as "easing."
- If the prices of goods and services begin to rise at a faster rate than is desirable, the Fed would tend to raise interest rates by decreasing the money supply to slow the economy down. This is sometimes referred to as "tightening."

HOW THE FED AFFECTS YOU

- Changes in the money supply affect a host of variables. It does take some time for a change in the money supply to affect the entire economy. Most consumers do not feel the results of monetary policy changes for between 8-18 months, depending on economic conditions at the time. Any changes in the money supply will influence the amount of credit that is available and the interest rates charged, as well as prices, employment, exchange rates, and consumer spending.

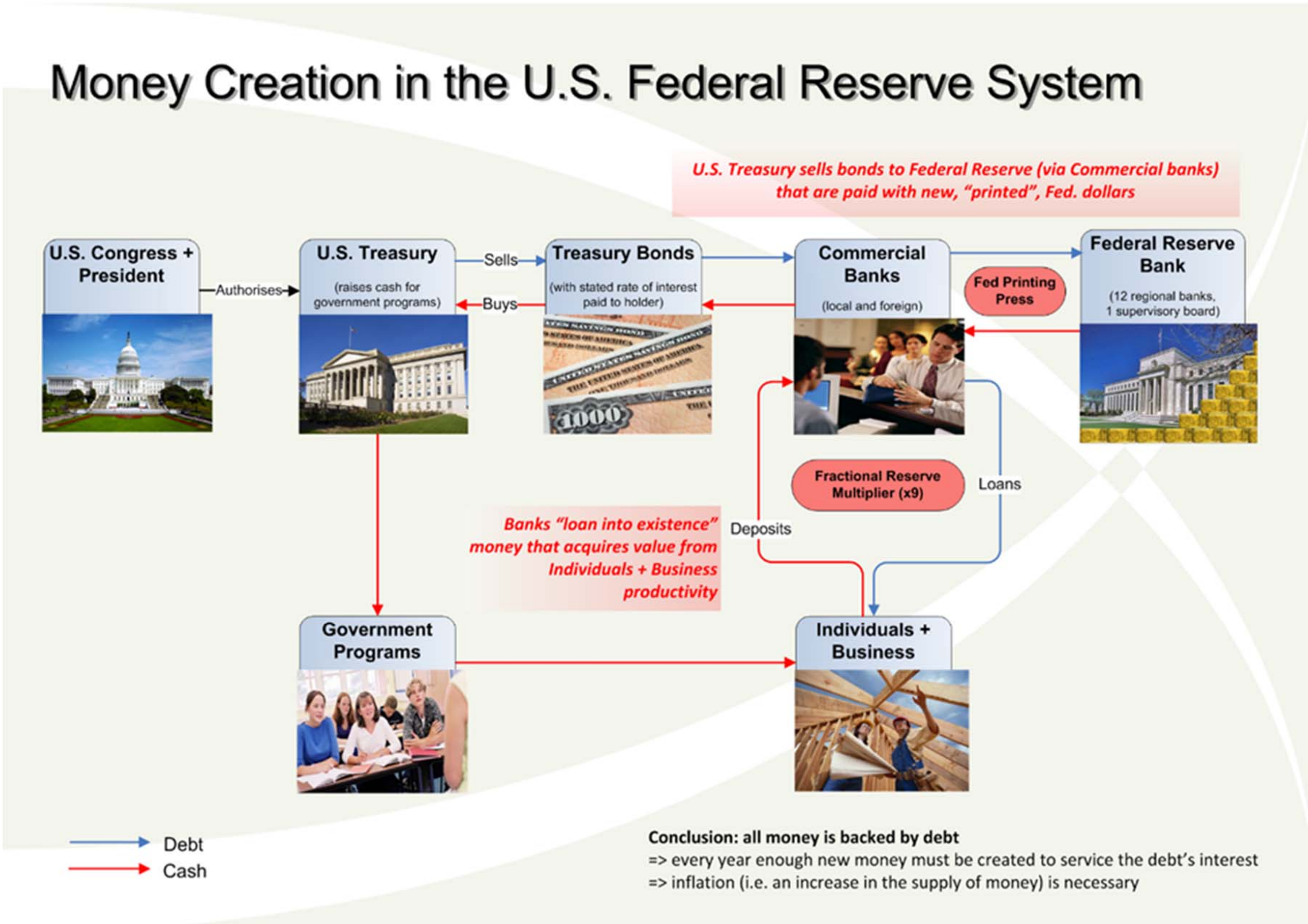
HOW THE FED AFFECTS YOU

The following points describe how decisions at the Fed affect you:

- The moves the Fed makes influence how much interest you will earn on a savings account, CD, or money market fund.
- Changes in monetary policy often have an effect on stock prices, which may affect your retirement plan.
- Monetary policy influences interest rates on auto loans and credit cards.
- Rates in the bond markets are influenced, which in turn will influence the interest you pay when applying for a mortgage. If you have an adjustable rate mortgage, Fed policy may even cause your monthly payment to change.
- The Fed can affect your job situation. Changes in interest rates influence when businesses expand and hire or cut costs and fire.

By controlling the money supply, the Federal Reserve System can have a significant impact on our financial well-being. Having an understanding of what the Fed does and how it can affect us is important for everybody

THE PROCESS OF MONEY CREATION



www.workableeconomics.com

Fractional Banking System

Money creation

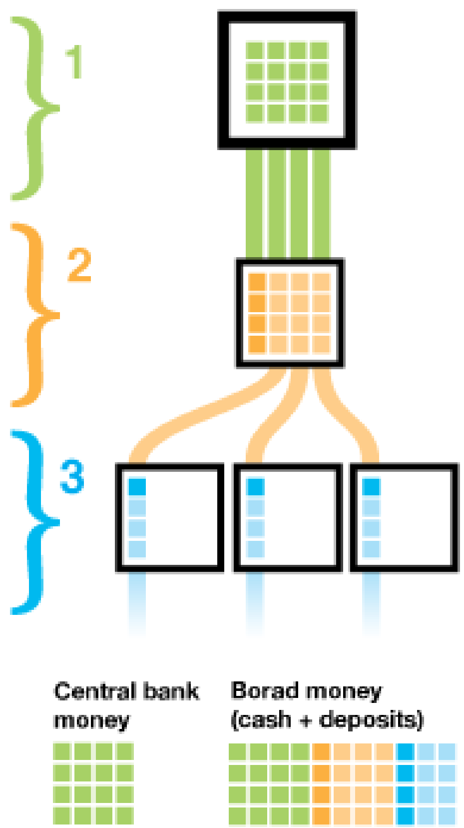
through fractal reserve banking (expansionary monetary policy)

CENTRAL BANK
extends a loan to a commercial bank: New commercial bank money is created. Central bank can also create money by purchasing financial assets.

COMMERCIAL BANK
keeps the required fraction of loan sum as deposit, and extends a loan to other commercial banks.

OTHER BANKS
also keep the required fraction as deposit, and are free to re-loan the rest. **Because the loan counts as money, the total monetary supply increases.**

As a loan is paid back, more commercial bank money disappears from existence. Since loans are continually being issued in a normally functioning economy, the amount of broad money in the economy remains relatively stable.



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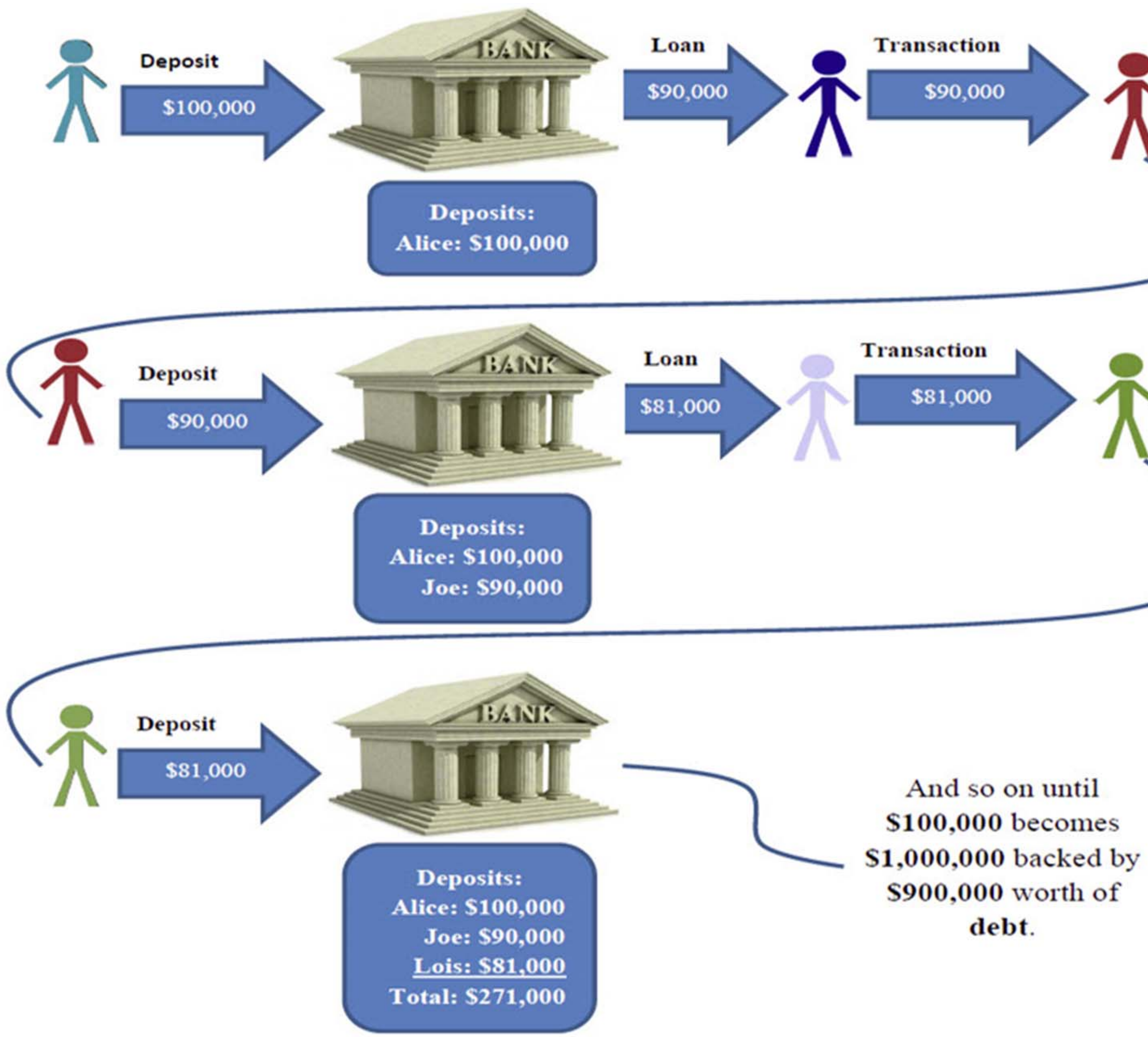

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FRACTIONAL RESERVE MULTIPLIER EFFECT

- "Fractional reserve" refers to the fraction of deposits held in reserves. For example, if a bank has $500 million in assets, it must hold $50 million, or 10%, in reserve.
- Analysts reference an equation referred to as the multiplier equation when estimating the impact of the reserve requirement on the economy as a whole. The equation provides an estimate for the amount of money created with the fractional reserve system and is calculated by multiplying the initial deposit by one divided by the reserve requirement. Using the example above, the calculation is $500 million multiplied by one divided by 10%, or $5 billion.
- This is not how money is actually created but only a way to represent the possible impact of the fractional reserve system on the money supply. As such, while is useful for economics professors, it is generally regarded as an oversimplification by policymakers.

THE BOTTOM LINE

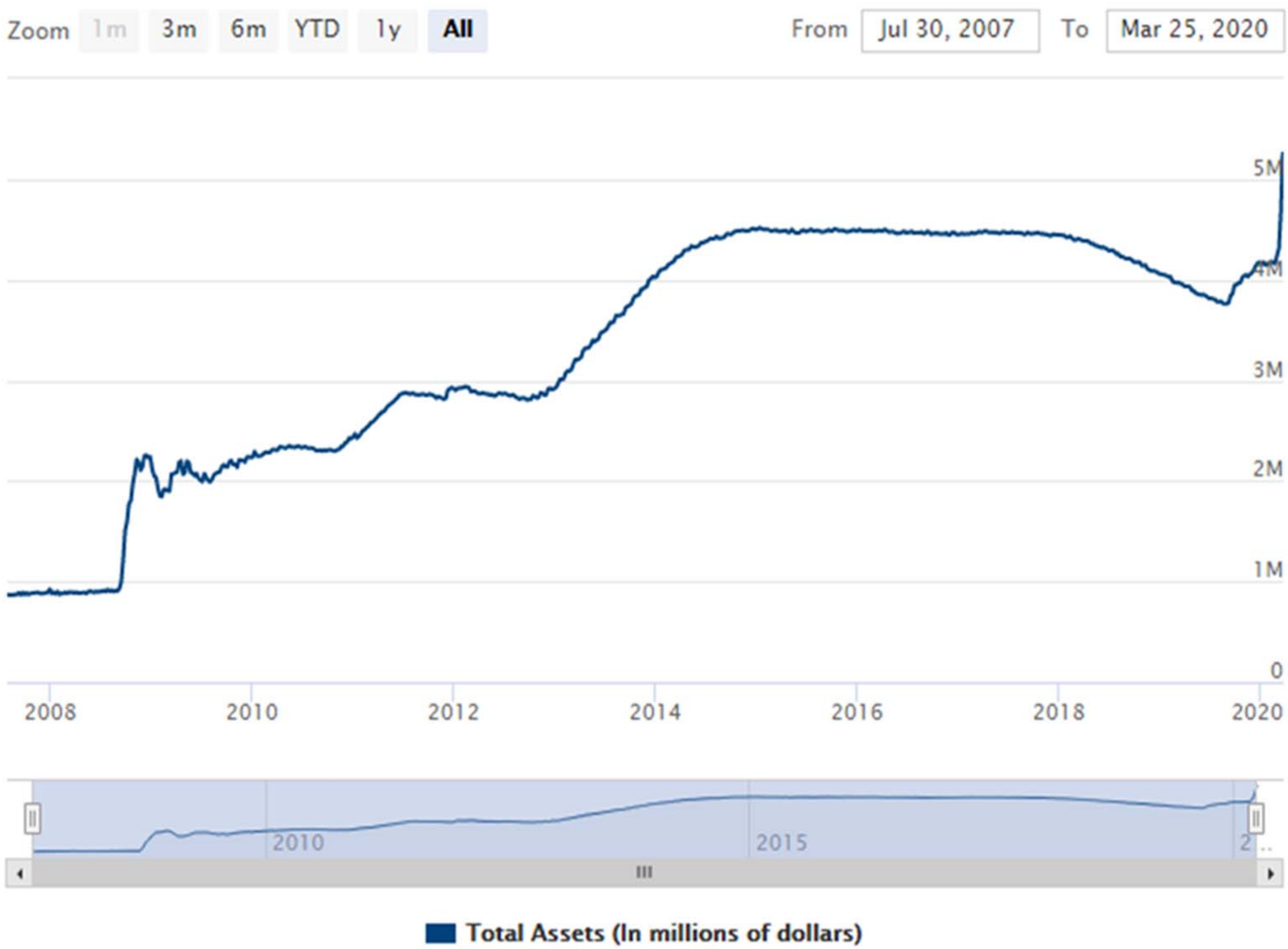
Fractional reserve banking has pros and cons. It permits banks to use funds (the bulk of deposits) that would be otherwise unused to generate returns in the form of interest rates on loans—and to make more money available to grow the economy. However, it also could catch a bank short in the self-perpetuating panic of a bank run. (Many U.S. banks were forced to shut down during the Great Depression because too many customers attempted to withdraw assets at the same time). Nevertheless, fractional reserve banking is an accepted business practice that is in use at banks worldwide.

THE ACTIONS THAT ARE BEING TAKEN NOW BY THE FEDERAL RESERVE AND THE U.S.TREASURY ARE UNPRECEDENTED!

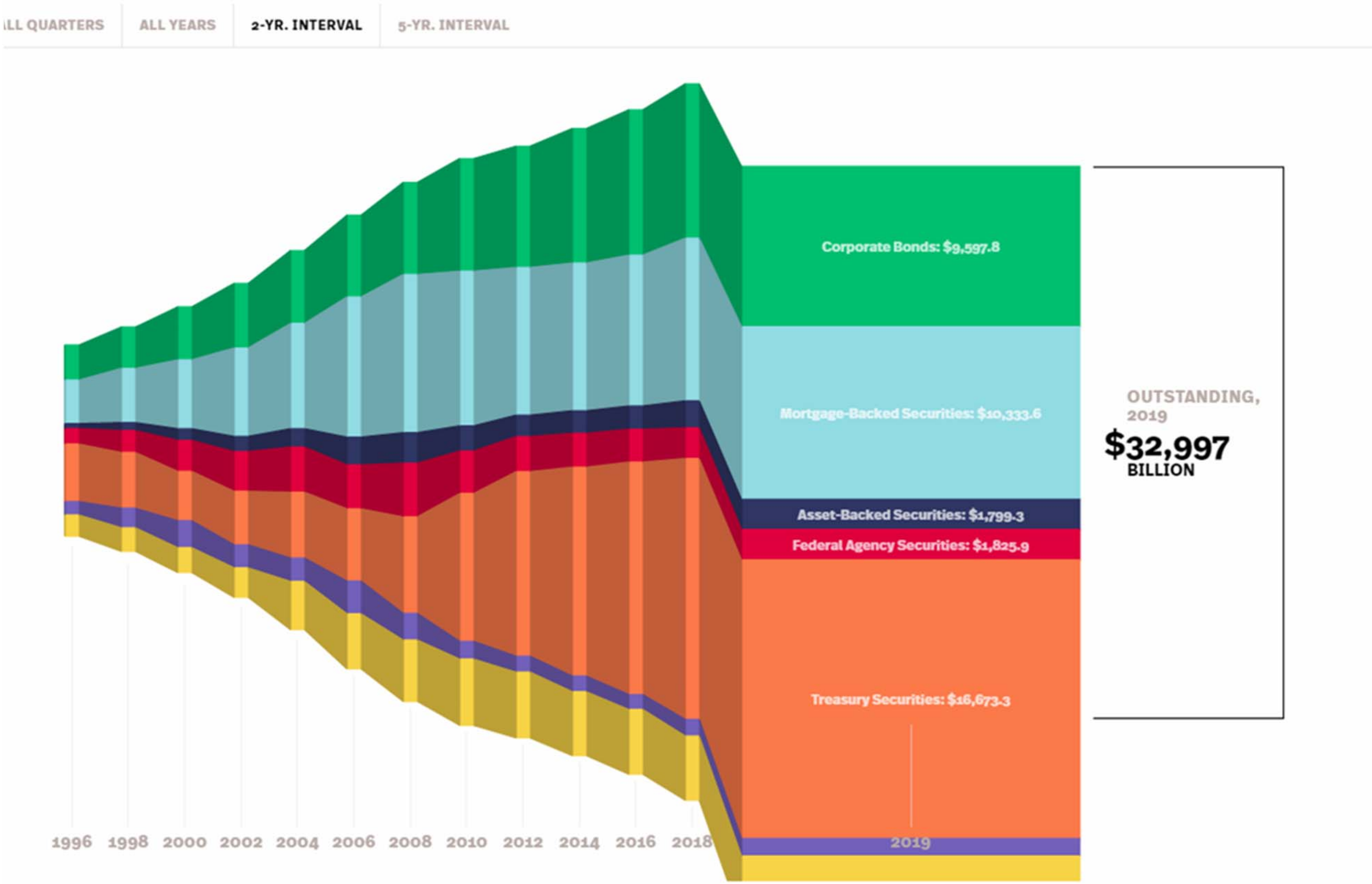
https://www.investopedia.com/terms/m/multipliereffect

TOTAL ASSETS OF THE FEDERAL RESERVE

The Federal Reserve's balance sheet has expanded and contracted over time. During the 2007-08 financial crisis and subsequent recession, total assets increased significantly from $870 billion in August 2007 to $4.5 trillion in early 2015. Then, reflecting the FOMC's balance sheet normalization program that took place between October 2017 and August 2019, total assets declined to under $3.8 trillion. Beginning in September 2019, total assets started to increase.



FIXED INCOME OUTSTANDING



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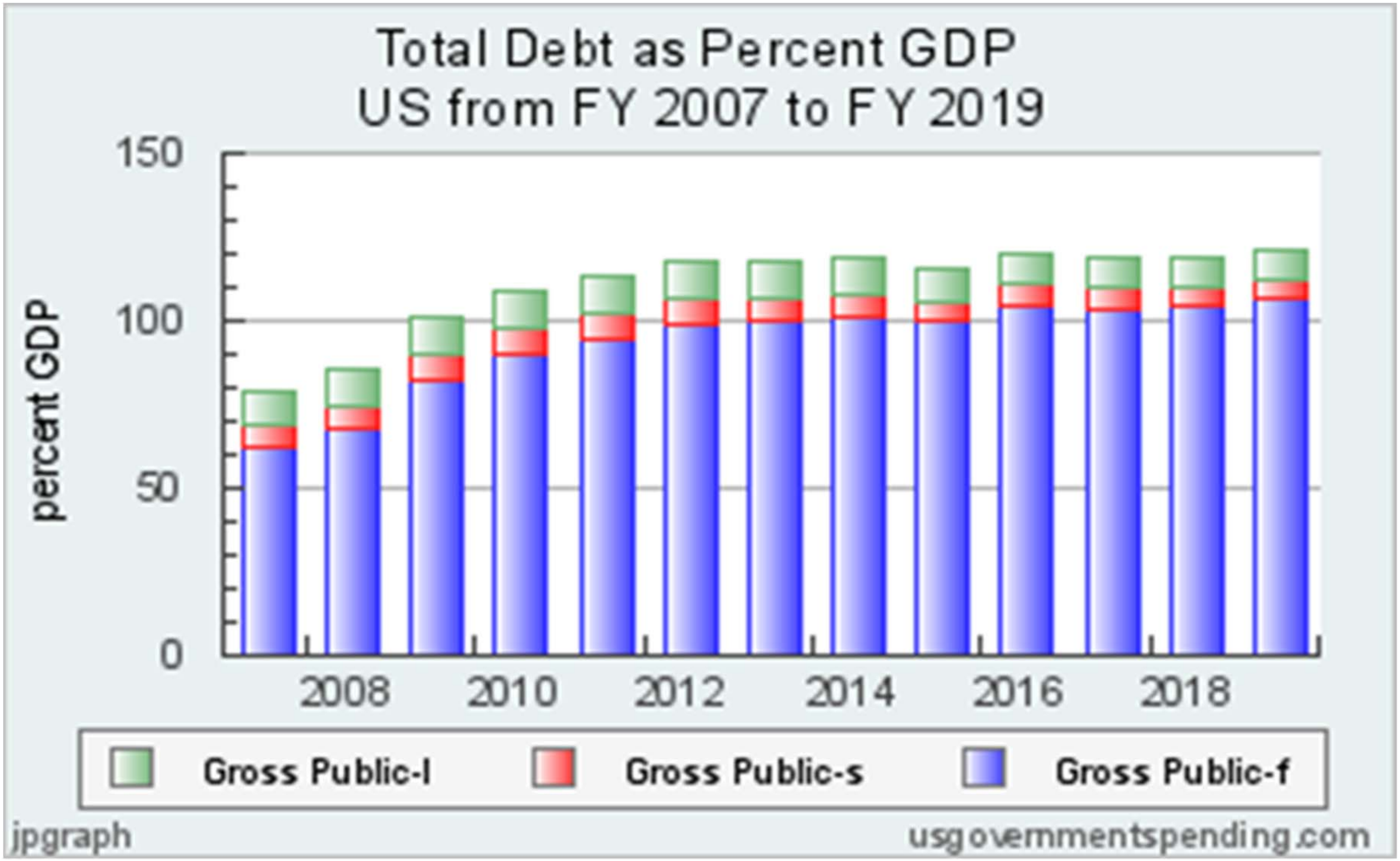
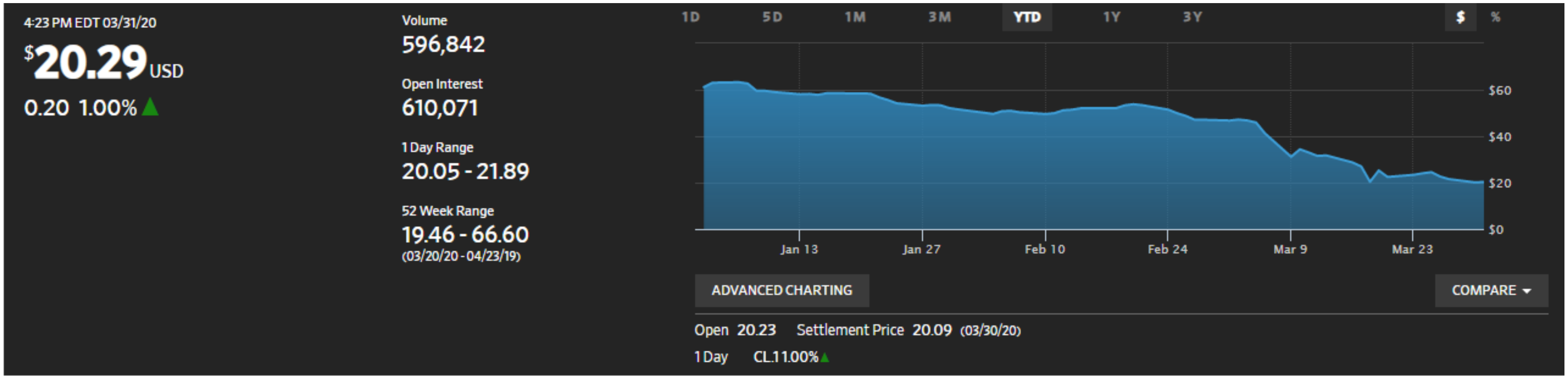
HOW IT AFFECTS YOU



Oil Markets



- Oil prices have fallen by more than half during the past month as companies cut back or close production

- Prices have fallen for two reasons:
  - Decrease in demand
  - Price war between Saudi Arabia and Russia

Source: Wall Street Journal

DISCLOSURES

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