

## Greenspan Loses Patience, But Leaves Rates Unchanged

By Laif Meidell – American Retirement Planners

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Published May of 2004 in the Sparks Tribune, Sparks, NV

On May 4, 2004 the Federal Reserve decided to leave short-term rates unchanged at 1%. However, that wasn't a big surprise to most Fed watchers who, for the most part, had figured this out beforehand. So what was left to worry about? Analysts decided to focus on what Alan Greenspan "said" in this month's statement compared to his last commentary in March. In short, the Fed removed prior assurance that it "can be patient" and replaced it with the idea that rates can be increased "at a pace that is likely to be measured." In other words, they can take time raising rates and do it in small increments. (Investors Business Daily 5/5/04)

This was the Fed's way of preparing us for a rate increases at some point in the future. It is critical to remember that the only interest rates the Fed controls are short-term rates. If we think about how much interest we are earning today in our savings accounts and money market accounts, we can see that they are very close to the 1% rate the Fed left unchanged last week. However, 30-year Treasury rates have risen from 4.6% in March to 5.50% on May 14, 2004. So, even though short-term rates have stayed the same, longer-term rates, like we pay on our home mortgages, have risen.

Many mistakenly think the Fed's interest rate decisions actually lead longer-term bond interest rates higher or lower, when in fact according to Dr. John Hussman the bond interest rates are far better at predicting changes in the Fed-controlled rates. In other words, the Fed typically lags the bond market when it comes to interest rate changes. The fact that investors believe the Fed is important leads to a self-fulfilling prophecy that has an impact on financial markets and should not be dismissed. Hence, we listen ever so closely to what they say to divine some meaning that in the end it is probably inline with what we already believe.

The second misunderstanding about the Fed policy is that the rate hikes are intended to slow down the economy. What the Fed is really trying to do by increasing interest rates is to slow down *demand growth* or growth in consumer demand for goods and services. When it raises rates its sole purpose is to ensure that consumer demand does not outstrip the economy's capacity to produce by so much that inflationary pressures emerge and cut sustainable growth short. The difference between today and the last-time the Fed aggressively raised short-term rates in 1994, is our current economy's job growth and capacity utilization. In 1994 the economy had been consistently generating 325,000 new jobs monthly, not just for a single month, like we saw in March of this year. Additionally, in 1994 the capacity utilization was 83 percent and the GDP had grown at a rate of 3 percent for 8 quarters. This was considerably higher when compared to today's recent capacity utilization of 76.5 percent and four quarters of GDP growth above 3 percent. (weekly market commentary by Dr. John Hussman, 4/19/04)

I believe that today's capacity utilization and current job growth indicate that the Fed is not in a hurry to raise short-term rates because consumer demand is not threatening to exceed the capacity to meet those demands. If we are waiting for the Fed to tell us when interest rates are heading higher or inflation is becoming a threat, the train will likely have already left the station. Let's keep our eyes on what longer-term interest rates do since they are the best indication of economic and inflationary trends.

Laif E. Meidell is Vice President of American Retirement Planners and a NASD Registered Representative and Registered Investment Advisor with Associated Securities Corporation. He is a Registered Financial Consultant and has an MBA in Finance and Accounting.