

**Key Points**

- ◆ Fed action hasn't changed debt growth
- ◆ Debt growth can be a catalyst for growth
- ◆ Debt can also be a drag on the economy



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**Out of Control, Pt 2**

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A few years ago we produced a research piece that showed how the Fed was not in as much control of things as you might think.

Friday's action with the Dow down 400 pts and oil up over 11 Dollars underscores that point. Unemployment jumped the most in over 20 years and the Fed's hand is being forced into doing something it doesn't want to do.

When the Fed lowers and raises interest rates, they are trying to affect the economy by influencing the money supply. If they want to give the economy a boost, they lower rates, thereby increasing the money supply and the economy gets a bit more fuel to get moving. If they want to slow the economy, they raise rates, decreasing the money supply and slowing the economy.

Statistics confirm that as the Fed raises rates, the money supply growth slows and as they lower rates money supply growth increases.

But how does the money supply actually go up or down? Does the Fed print money and throw it out the windows of the tallest buildings? No, actually one way they affect the money supply is through the banking system via loans. As rates go up, less people want to borrow, as rates go down, there are more borrowers.

There is a point at which new debt can be a catalyst for new economic growth and at another point it becomes a drag on the economy. If the debt ratios are getting out of hand, the Fed can raise rates to slow the growth of debt and the economy. If the Fed does not act, the economy could collapse under the weight of the excess debt burden.

So we should see this in the statistics, shouldn't we? The chart to the right shows various periods of the Fed raising rates and lowering rates and what the growth of debt was during those time periods. But the Fed doesn't raise or lower rates for the same amounts of months

each time. So we divided the overall growth of the debt by the number of months the Fed maintained a particular direction of the Federal Funds Rate. In this way we are able to compare different time periods where one may be significantly longer than others.

What we found was nothing. It didn't matter what the Fed was doing with interest rates. Debt growth seemed to be unaffected by rising or declining interest rates over the past decade.

In the early 1990's, the Fed dropped rates by 63%. Then they doubled rates in almost a year and a half. Total Debt growth during both periods was almost identical.

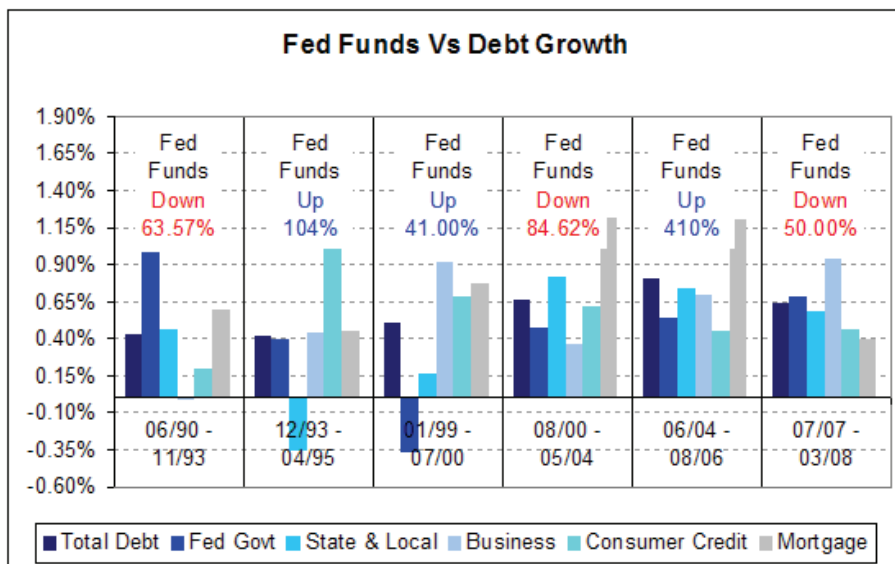
In the late 1990's rates went up about 41% and debt grew more than in the early 1990's when the Fed was dropping rates. (Debt growth should have slowed.)

From August 2000 through May 2004 the Fed lowered rates by 84% and debt, as one would expect, rose even more than the previous period, when the Fed was raising rates.

But then the Fed raised rates over 400% from June 2004 to August of 2006, and shockingly debt continued to grow even faster than when they were lowering rates.

What this tells us is that something else is influencing the growth of debt and the Fed is ineffective and has lost whatever control they (and Wall Street's marketing machine) thought they had.

Now comes 2007 and the Fed's panic move to lower rates starting in July. (See the [Fed Buys A Round](#)) Instead of the expected increase in debt growth, its growth has slowed. This doesn't bode well for the Fed's plans to keep the economy from recession.



Source: Fed Reserve; Format CIS

## Key Points

- ◆ Trends are already in place - Fed can't do anything about them
- ◆ Rising rates hurts the economy
- ◆ Lowering rates hurts the Dollar and brings on inflation

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2008 brought even more challenges as the derivative mess and sub-prime mortgages forced the Fed to play "Bail out of last resort" for investment bankers that took on too much risk and lost the game. (See [Trillion Dollar Secret](#))

But the Fed is also doing a balancing act. The Dollar has been collapsing for several years because of the Fed's loose money policies and the growth of debt. So to protect the Dollar, the Fed has to raise rates, which it was doing, to no avail, until July of 2007. Then along comes the housing crisis and the banking crisis and the derivative crisis and the Fed has to lower rates like crazy to keep the economy from caving in. This also greases the skids for the dollar to slide even further down.

Then we have oil decide to skyrocket, pushing inflation higher and the Fed needs to raise rates to fight inflation. But they don't, or haven't yet.

And then, after weeks of speculation, another investment bank, Lehman Brothers, is in need of cash ([Lehman Raising \\$6B in Capital: Expects \\$2.8B Loss](#)) to stay afloat, unemployment jumps to 5.5% and the market drops 400 points. To bail out the banks, again, and give the economy a boost and keep the stock market humming, the Fed needs to lower rates.

Except that along with this week's news, the Dollar dropped some more. To protect the Dollar and fight inflation, the Fed needs to raise rates.

Which brings us back to the chart above and the point of this report, the Fed is out of control. It no longer controls the things that make a difference to the economy. There is nothing they can do to reduce the consumption of oil and other commodities by delveloping nations overseas. There is nothing they can

do about the growth of debt in this country. There is nothing they can do about the time bombs of derivatives and sub-prime mortgages and other esoteric investments buried in the balance sheets of our nation's top banks.

They are not willing to take the necessary action to protect the Dollar and fend off inflation. Raising rates would hurt the economy. Lowering rates hurts the Dollar and brings hyper-inflation.

What is the Fed to do?

The way we see it at Cornerstone, the trends are already in place and there is little the Fed can do about them. They can delay and they can interfere, but the macro trends are too powerful and the Fed is powerless to do anything about them. They will talk, they will change rules, they may even do something with interest rates. But this week's action, more than anything else, showed that the Fed was out of control on the issues that matter.

Investors are not powerless though. There is a wide range of investment vehicles that can take advantage of the problems that are giving the Fed a headache.

### Summary:

Regardless of what they want you to believe, the Fed has become ineffective against the real problems and is unable to do anything to reverse the trends that are in place.

Nothing is surprising us though and our strategy is taking advantage of much of what is causing the market fits.

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