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Interest Rates Must Rise to Market Levels for the Economy to Boom

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The Fed is following a policy of financial repression in order to keep interest rates low. This policy is comprised of a combination of low short-term rates and buying long-term debt. The Fed's primary objective is not to stimulate the economy, per se, but rather to keep interest rates low in order to also keep government debt payments artificially low. By doing so, the Fed reduces pressure on the federal government to raise taxes and reduce spending, which they believe will harm growth. Financial repression was practiced around the globe after World War II, as governments struggled with the extreme debt burdens created by war-related defense spending. It also has taken place in Japan for the past quarter-century, as run-away Japanese government spending has created debt levels that are impossible to service if interest rates were to rise to market levels.

As has been made abundantly clear by the Japanese experience, financial repression drains resources from the private sector and transfers them to less productive government use, thereby creating negative economic arbitrage and reducing economic growth accordingly. As a result of financial repression, savers have had hundreds of billions of dollars expropriated by artificially low interest rates. As we have noted, if only 10% of the reduced interest payments over the past 7 years had been used for down payments on new single-family homes, single-family housing starts would be running at their historic norms. But instead, lost interest income has rendered many young savers incapable of achieving the down payment necessary to purchase a home. At the same time, their grandparents have had their interest income on their life savings reduced to the point where they are uncomfortable making the usual intergenerational transfers that assist the younger generation in purchasing a home. And while the monthly mortgage payment is reduced by artificially low interest rates, this is of no assistance to someone who cannot assemble the necessary down payment.

The Fed's artificially low interest rates have hopelessly distorted capital markets over the past 7 years, dramatically misallocating

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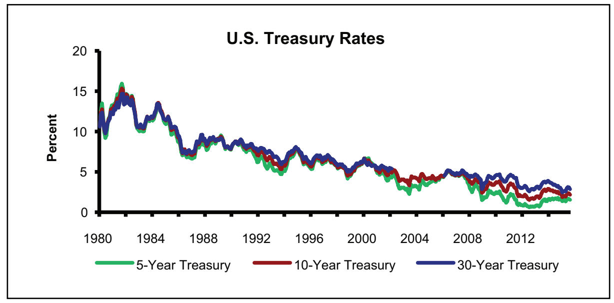
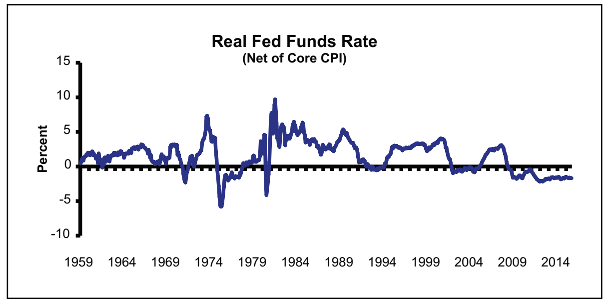
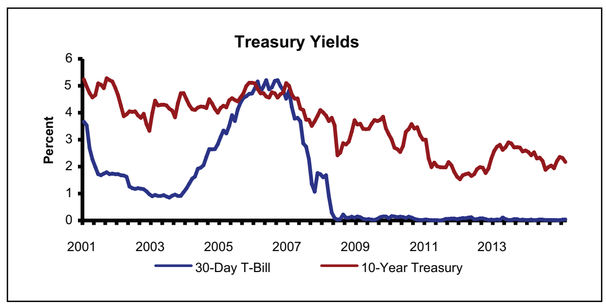
scarce capital. Far too much has gone to high credit borrowers, most notably the U.S. government, and too little has been allocated to entrepreneurial companies. The result has been a reduction in economic growth over the past 7 years as we support government spending, rather than more productive private sector activity. This lesson, which has been amply on display in Japan for the past 25 years, has been completely ignored by the Fed. In fact, U.S. real per capita GDP growth rate from 2008-2013 was 1.9%, versus 2.3% for Japan. This is a shockingly small differential in light of the dramatically more entrepreneurial nature of the U.S. business sector. But giving more cheap money to governments is almost always a poor use of capital, as it transfers resources from the private sector to the less productive government sector. Every dollar so transferred generates a negative "bang for the buck," and over the past year 7 years, we have transferred roughly 40% of GDP from the private sector to the public sector. If governmental use of resources is a mere 10% less efficient than the private sector, this transfer has generated a 4% loss of GDP in 7 years. This is almost $700 billion, or $2,100 per person. Viewed differently, it has knocked about 60 bps off of real GDP growth per annum, which is roughly the amount by which real GDP per capita has lagged its long term trend. The result is also a government bond bubble which is at least as destructive as the tech and housing bubbles, when too much capital was poured into those sectors instead of being allocated to higher productivity areas of the economy.

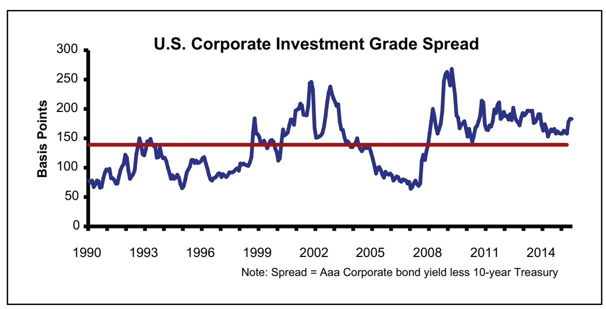
Current individual Fed member forecasts for the short-term interest rate have a dispersion of nearly 250 bps for year-end 2016, underscoring the fact that the Fed is not comprised of all-knowing geniuses. Were this the case, not only would their forecasts have been unerringly accurate over the past 7 years (instead of being among the most inaccurate forecasts of any forecasting organization), but they would all agree on exactly where interest rates would be in 15 months. Their forecast dispersion reveals that they are clueless.

The Fed, the ECB, and the Japanese central bank continue to kowtow to the imagined threat of deflation through low interest rates and easy money. But there is no deflation, especially in the U.S. Declines in consumer prices in the U.S. are driven by declining energy and falling goods prices brought about by technological









improvements and declining energy prices. These factors improve the standard of living of Americans and do not merit policy concern. Meanwhile, the prices of services and assets continue to rise. Similarly, there is no deflation problem in Japan. Japan's problem is not too little liquidity causing prices to decline, but rather too little economic dynamism and a shrinking population causing no growth. But monetary policy cannot make the population grow, nor can it eliminate the many market rigidities and a lack of entrepreneurial spirit that handicaps the Japanese and most European economies. These problems can no more be solved by monetary policy than monetary policy can make hair grow on bald heads. Let's face facts: monetary policy cannot stimulate hair follicles, nor can it stimulate moribund economies hampered by excessive regulations and poor demographics. Money is merely a medium of trade, not a magical "cure-all" elixir.

The biggest challenge facing the U.S., and global, economy over the next 2-3 years will be coping with the uncertainty of what happens in the face of rising interest rates. In fact, the uncertainty about what happens in the face of interest rate increases is probably a greater challenge than the reality of rising interest rates. This is because as interest rates rise, market participants will again be able to read them as indications of where best to allocate scarce capital. Rising interest rates will stimulate growth, but this will be, to some extent, offset by uncertain-ty about "what will happen." Because this is a unique situation, no one has an experiential base from which to project what happens when rates rise back to market-driven levels from such a prolonged period of artificially low rates. And as we have noted many times in the past, uncertainty is the enemy of economic growth.

10-Year Govt Bond Yields

	Dec. 2006	Sept. 2015
Switzerland	2.49%	-0.30%
Japan	1.65%	0.36%
Germany	3.77%	0.77%
France	3.81%	1.16%
Ireland	3.76%	1.38%
United Kingdom	3.82%	1.94%
United States	**4.54%**	**2.29%**
Spain	4.04%	2.12%
Italy	4.70%	1.92%
Poland	5.14%	2.94%
Portugal	3.96%	2.70%
China	3.06%	3.36%
India	7.60%	7.75%
Brazil	11.20%	5.66%

Source: marketwatch.com