FOUNTAINHEAD INSIGHTS

Market Commentary: The US Treasury - Federal Reserve Connection & Associated Implications, *January 2021*

Janet Yellen has made history. She is now the only person to serve as both the head of the Federal Reserve and the U.S. Treasury[i]. A client recently asked for the distinction between these two institutions. Let's explore the function of each institution and implications both as a nation and from an investing perspective.

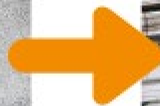
The U.S. Treasury is responsible for managing all federal finances. That means collecting taxes (the IRS is a bureau of the Treasury), printing money, issuing debt, and general management of federal finances. Conceptually, the U.S. Treasury could have simply printed money at the initial depths of the country's COVID related slowdown, but instead elected to issue debt – borrow money. The primary reason they did not print money is that this would have likely created inflation. By expanding the money supply, the value of cash would decline resulting in the need for more dollars to buy everyday products.

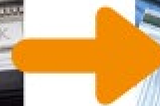
Instead, the U.S. Treasury borrowed the money. It seems like a technicality but what it does is balance the ledger. Some group of people lent the government money which tightened supply and then the government gave the money back out to a different set of people which loosened it back up. There is some wealth redistribution going on here!

> Money feels esoteric so let's use Gold as an example:
> An ounce of Gold cost $1822 on the day this is being written. We have a very good idea of how much extracted Gold (as well as still in the ground) exists today. If suddenly, we found a new source for Gold that expanded the amount available by 1/3 then the value should drop to $1366 per ounce.

In the fourth quarter of 2018, the Federal Reserve ("Fed") increased interest rates while the administration was waging a trade war on China. The market did not like this. While the U.S. Treasury is part of the Executive Branch of government, the Fed is the central bank of America, serving as both the government's bank and private bank's bank (tongue twister…). While it conceptually is independent and can disagree with government, the Fed and U.S. Treasury tend to work together for the benefit of the nation. Its main objective is to maintain (1) stable prices and (2) full employment. The Fed lent a material amount of the money borrowed earlier in 2020 by the U.S. Treasury to assist in funding its constituents due COVID.

[ii]





Government issues Bonds
(Borrows Money)
Gives Money to Constituents
(People, Business, Local Gov't)

Federal Reserve Buys Bonds
(Lends Money)
Federal Reserve Borrows from Banks
(Borrows Money)

Bank Lends to Federal Reserve
(Reserve Funds)
Potential implications on further bank activities

Implications:

- **Fed has a term mismatch:** They are lending money to the government on a longer term basis (on average about 5 years) and borrowing on a shorter term basis (overnight) which creates risk that ultimately affects taxpayers.
- **Pressure on bank activity**: Reserve Funds have negative consequences on certain bank ratios, potentially crowding out other lending activities – Higher Reserve Funds is expected by some (note footnote 2) to result in higher savings and less loans (which seems to be playing out), negatively affecting economic growth.

Our countries COVID related slowdown can be considered deflationary and resulted in many unemployed and potentially bankrupt companies. The Fed looked to stabilize prices and support employment by dropping interest rates and lending lots of money (technical term) to the government. The government in turn also looked to support its constituents (US citizens) by giving lots of money to business and unemployed for numerous reasons.

From an investing standpoint, the implications of the US dropping interest rates to 0% and essentially joining the rest of the developed world (Europe, Japan) in super low and sometimes negative interest rates, as well as the US being the most aggressive in its stimulus package, has resulted in a weakening dollar. And many believe the dollar will continue to weaken – if this occurs it will be a tail wind for international investing in both equities and fixed income. Given all the borrowing, the Treasury, and the Fed, both dramatically large institutions, have an interest in keeping rates low generally.

At the moment, in the absence of inflation or real economic growth, there does not seem to be an impetus to raise rates and the world continues to be awash in cash (albeit due to it also being awash in debt) and based on the systems in place, it's also 5hhard to believe that demand for government bonds will dry up any time soon (especially considering the Fed can soak it all up and stick on bank balance statements) – but there are still implications that play out as noted above – which negatively affect growth.

In short, one can start following the thread of how government borrowing filters through to the banks, interest rates and the shape of the interest rate curve, economic growth in this country, and the strength/weakness of the dollar which has further implications globally. Not only does this affect interest rates, which are at historical lows, and therefore investments in bonds, but also global equities, and most importantly, the US economy. Janet Yellen obviously has the experience and background to be a great Secretary of the U.S. Treasury which will hopefully serve to lead and assist in navigating us through a very complex and trying economic environment.

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[i] The official title for the head of each department is "Secretary" of the U.S. Treasury and "Chair" of the Federal Reserve

[ii] BPI (Home Page - Bank Policy Institute (bpi.com)) provided the best education on the Reserve Funds element of the Federal Reserve's balance sheet. There are a number of interesting articles on this "Nonpartisan research site" including: When the Fed Buys a Treasury Security, the Debt Does Not Go Away - Bank Policy Institute (bpi.com) It is worth noting that it does represent banks so while they are not biased politically (non partisan), they are biased towards their constituents, the bank. So my implications may be biased. Perhaps more fair is the statement that there are consequences for actions and so while we are not creating money out of thin air, redistributing wealth in the manner we did it (or really any manner) will have consequences.

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