Title: Medicine for the Economy

0:00:17 Andy: Hello, Andy Tanner here, welcome to The Cash Flow Academy Show. Cash Flow Academy Show, that's a rhyme, I'm a poet and I didn't even know it. Welcome and congratulations for tuning in, we've got some great things to discuss together today as you commute or exercise or just relax or drive or whatever it is you do, just we'll learn about cash flow. But I do congratulate you for tuning in, it's just I'm always impressed with people that take time to invest in self and it's my hope and my anticipation that you'll learn some things today, even if you're reminded or refocused, there's a saying that says it's every bit is important to be reminded as it is to learn something new. And so for those of you that have studied this a little bit, this will be awesome to remind us of what a big deal this is and how huge it can be.

Today, we're gonna talk about Federal Reserve, the Federal Reserve System and it's fun because it's not taught in school. I have a trainer, doctor says I got to keep losing weight so I've been pretty good and I go to a trainer every couple of days, he goes and he works me to death and he was asking me, he says, you do stocks and stuff, right? I say, yes, I'm like that. And he says, we start talking about the Federal Reserve and I said, you know what I came from? And it kinda struck me, I say, no, I don't. He said, I got here, it does. And we had an interesting conversation.

In the United States where I live and I'm hoping the education where you live is better, I don't know that it is, it might be, but we have 3 branches of government here, we have a legislative branch which is our congress, you might have a parliament, whatever it is. We have the house and senate, you might have a parliament with different factions as well, they make the laws. Then we have an executive and you might have a prime minister, we have a president of The United States, we also have a Supreme Court, a judicial branch. And then the schools, they teach about those branches of government.

Well, the Federal Reserve is not really part of the government, they're private entity working within the framework of government but central banks, I think that every bit is important to study in school is how does a federal bank or central bank or where does currency come from and it's not something that's taught. Well the reason I thought this would be a great topic is not too long ago. Jen Yellen, the head, the Fed chairperson, the chair of the Fed said, hey, we're gonna keep interest rates the same for a little while. Now, let's talk a little bit about why this is significant and the games that people play with this and why people hold their breath before she speaks and makes policy. Few shows ago, we talked about risk, we talked about policy risk, when they change a policy, it changes things. So people are gonna pay attention so what is this all mean?

Well first of all, let's talk about a few of the Fed's duties and before, I don't think this is the best podcast to do a history of it, maybe we get Ed Griffin on the show to do that for us. He wrote a wonderful book if you like to read it, A Creature from Jackal Island, it's a very intense read. He's a wonderful storyteller and when people learn about how the Fed came to be. He wrote about the Fed, I wrote about the 401k and they're both just bogus. They both started with the strangest of circumstances, neither of them started with the idea that we're gonna really help this little guy, I'll tell you that right now. So regardless of the history which is for another show, now that it's here and we've inherited this system, what do they do? So there's a lot of different things they can do but let's just keep it simple to 3 or 4, maybe even 2. Some of the ones that are less front and center, they determine the reserve requirement for a bank, for what's called fractional reserve lending. In other words, if they wanna lend out 100,000 dollars, how much actual money do they have to have to lend things out in to existence and stuff like that, lend money in to existence. And so if there's run on the bank, how much of the money do they actually have to have on deposit? Can they lend out more than they have? The answer is yes, they can which makes banking a heck of a business. But more to the point of this podcast, I like to say 2 things they can do, they have many things they can do but the 2 main ones are these, first of all is they can change the rate with short term loans happen from the bank, in other words, the bank can borrow money and they can loan money. And so the rate at which money is, how much is it cost to borrow. The second thing they do is they can print money, they can invent it out of nothing and the fancy word for that is called quantitative easing. So let's talk about both of those.

So the Federal Reserve if you go to their website, I don't remember what it says, the Federal Reserve, I don't even know how to get there, is it FederalReserve.com? Maybe I could bring it up here. FederalReserve.gov or whatever it is. And if you say about the Fed, they'll have the people there and what is this about and what is the Federal Reserve board and the Federal Reserve System and all these type of stuff. And what they really do is they work within a framework of the government, they have a mandate to keep the currency supply balance, in other words, price stabilization, they don't wanna have too much inflation, they don't wanna have not enough inflation, they wanna keep prices controlled and stable. They also want employment, they care that people have jobs and those are really true, their big mandates.

So to manipulate prices, they can expand the currency supply or they can contract it and they do this by buying government bonds or mortgage backed securities with money they don't have. See? If they wanna flood the market with money, they wanna put, banks put a lot of money in the hands of the banks, they'll say, hey, got any bonds? They say, yeah, we got a lot of bonds. They'll say, we'll buy them from you. And so they'll make attractive offers and so the bonds go on to the balance sheet of the Federal Reserve and the cash goes in to the banks and in to the system. Well, the problem with that is is they buy these bonds with money that doesn't exist yet. See? They just click a button and that money comes in to existence. So as they take these bonds under their balance sheet, all these money comes in to existence, well, I'll be done when the currency supply has expanded and that can be value a dollar which they may or may not want to do. They wanna do the opposite, what do they do? Well, they give the banks an offer they can't refuse and say, hey, we'll sell these bonds at a discount man, we'll sell them way discounted and the banks will say, well that's an offer we can't refuse, I mean, that's taxpayer money, right? They're gonna pay those bonds, it's pretty safe, we'll buy those bonds from you and all that money that banks have, the currency, goes in to the pockets of Federal Reserve and now they get bonds, now the currency supply has been reduced.

Now, there's more complexities in that, that's I like to keep stuff simple but that's the essence of it and that's called quantitative easing, quantity, right? Quantitative, quantity, they're gonna make it easy to increase the quantity of money that is out there so they call it quantitative easing, QE for short. They'll use jargon, they'll say, we're going to expand the balance sheet of the Federal Reserve. What is the meaning of expand their balance sheet? They're gonna take on assets, they're gonna buy bonds which is funny because a balance sheet should balance, you shouldn't be able to expand it, it should be balanced. So they'll say, we're gonna monetize the debt, that's another, it's just this jargon. Well, monetize means turn something in to money, right? So maybe there's a debt like a bond or a mortgage backed security and they're gonna give banks money for that debt so they're gonna allow them to monetize the debt and that's all code, it's Bernankes, it's Yellenies, it's Federal Reserve speak for we're gonna invent some money here. So that's the first thing they do.

Well, Ben Bernanke, he just put the pedal to the metal, I think they bought about 4 trillion dollars' worth of bonds during his tenure more and so there's a lot of money flying out there, people were nervous with inflate hasn't done much yet, I think a lot of this money is still in the banks and some keeping on deposit on the Fed. The quantitative easing ended about a year ago, they quit buying these mortgage backed securities, they quit buying these bonds and so they've quit pumping money in to the system. Well, the other thing we can do is we can borrow money in to existence and if we give people a low rate, they'll be excited about borrowing in the lower rates, that seems to lubricate commerce, it seems to make money flow faster when it's cheaper. And so that's the second thing they can do in addition to quantitative easing, they can say, hey, we'll change the rate at which it cost to borrow money, what does it cost to get money. And we've had rates basically at zero, it's like .0125% which is basically zero. Your parents like .005%, they're like way at zero and so it's supposed to be a shot in the arm.

Well, the problem with quantitative easing and having a low interest rate is they do this in the context of medicine, I mean, explain what I mean. Let's say someone is brought in to the emergency room and they're having a heart attack, what do they call it? A cardiac or mild cardio infarction or whatever their jargon is, they're having this heart attack and they got all these symptoms, they got shortness of breath and nausea and chest pain and pain down their left arm and they fit the age group, they're little portly and they're about by age and middle age or older and next thing you know, we got a heart attack going on. So they'll hook up an IV and they'll throw in some dialectics to expand their arteries and they'll throw an oxygen mask on to get the oxygen going and maybe they get intent to the point where they're in intensive care, I mean, they got to put them on a ventilator. So the next thing you know you're in intensive care and you can't live without life support. So the question is this: is life support good news or is life support bad news?

Imagine you come across the scene of an accident that your son or daughter have been in there, they're fighting for their life, they're about to sleep away. When the ambulance comes and they have that adrenaline needle or they have those shock pedals, are you excited about that? Well, on one hand, you are because help is on the way so maybe it's good news that the ambulance comes up. But from a bigger perspective, it's never good news if there's an ambulance involved in any way. So the market reacts to the Fed very much like we would react to paramedics, we can either say, oh no, the paramedics have showed up, that must be really bad. Imagine driving home to your home and seeing an ambulance in the driveway with paramedics rushing in, that would make your heart sink, that would be a bad experience. However, if you're in the middle of experience and you're hoping they'll come and when the paramedics show up, it might be a positive experience. So seeing paramedics can give you a shot of hope, a shot of optimism or it can scare you to death and that's the way the Fed works with the market and that's why it's so hard often to interpret how the market will see things.

Now, traditionally, most of the time when the Fed raises or lowers rates, that's medicine for the economy, that's people get excited, Wall Street gets excited saying hey, we're going to be able to do more business, money is gonna be cheaper, it's gonna be more available, we should see some profits, let's buy stock and let's go in this environment where there's lot of heroin moving around. Well, that's fine, that's traditionally it reacts very strongly to QE. However, if it's prolonged, if your parents have been on narcotics for 5 years, pretty soon, you'll start realize, boy, this is the overall health of this is really bad, we've been on medicine for a long, long time. Another thing that can happen is if they take your mom off of ventilator or off of her prescription, that might be exciting, that might be a sign of health but then again, boy, if she's addicted to that stuff, she might like that shot of heroin, she might get excited when she learns I'm gonna get another shot of heroin. So again, interpreting the Fed can be tricky, it really can because you're not sure what the market will agree as good news.

Now, what the Fed will do sometimes and Bernanke has done this a little bit, he was pretty good about it, Greenspan maybe less so, Yellen has not really made many changes other than to continue to reduce the QE to nothing. So what they'll do is they'll say something like this, well we're not gonna raise rates today but we see this pause, we might raise rates by the end of the year. So again, that can spook the market saying, oh no, the party is over, the heroin dealer is not gonna be coming around anymore or they might look in and say, well that's awesome, chair Yellen thinks the economy is doing well, well maybe that's, maybe we'll be able to make some money here, let's get in the market.

So since December, this most recent December since we stopped QE, came out of the QE stop, the next question is when are you gonna raise rates back to what we would consider a normal level? They usually raise them maybe a half point or a quarter point at a time and usually gonna be down abrupt but they're asking, when are you gonna raise rates, when are you gonna raise rates? They say, well, maybe end of the year, maybe end of the fiscal year, maybe September-ish, maybe get a little guidance on that.

So we were really bracing during this last announcement, we were really expecting chair Yellen to come out and say, okay, yah, we said the economy seems to doing well, employment seems to doing well, time to take you off the medicine. We've got the QE down now, let's raise rates. And they're bracing for everyone. Well just before the announcement, we had a flash crash in the market, we had China going bananas, we had some stuff that can cause what's called contagion where one country worries about another and all this fear goes on. And inciting that, chair Yellen came out and said, we were really thinking about raising the rate, we're thinking about doing it but we got all the China stuff going on and maybe, maybe things aren't as good as we thought so we're gonna leave them low. Well, how does the market react to that? Everything you say is awesome, we get more heroin for another month in low rates or they'll say, gee, you're supposed to raise them, you're supposed to take my mom off this medicine here, how can you not doing it? You must see things as being grave. So that's why we pay attention to the Fed.

Now, do I trade the Fed? No, I pay attention to it. This is one of the reasons why stop losses are so important and exit strategy and the fourth pillar of risk management is so important. I never try to guess the Fed, okay? I don't try to guess the Fed. The reason I pay attention is because the market might react. Now, I never know for sure how it will react or what the announcement will be so there's 2 unknowns there, I don't know what the announcement is gonna be, I have no way of knowing that. My feeling was in the mentor club the week before it happened, I said, hey Jen Yellen is gonna come out, we think in lie to this, China stuff rates will probably remain low and we were right but I got to tell you, that's not because I had some special inside, it's because that's the way I felt and she happened to agree or vice versa, I agreed with her. But I could've been dead wrong, it's the thing.

And so investing is not about being able to predict what the Fed will do because it's impossible to know for sure what the Fed will do in the short term. In the long term, we can see their hand being forced with QE later on, we can see their hand being forced with low rates later on but for the time being, week to week or excuse me, announcement to announcement, you don't know for sure. So I listen because I don't know and I also don't know not only what they're gonna say but I don't know how the market is gonna react to it either. So now, any time the Fed speaks, I'm dealing with 2 unknowns and it's a lot like any other event like earnings, I don't know whether a company makes earnings or meets the expectation or fall short, I just don't know. So what that tends to have me do is A: I pull back a little bit and I know when to take my ball and go home, I make sure that things are hedged well, I make sure that things are insured well because a Fed statement will move the market, that's why we listen, not because we can predict it but because we think it could, it's one of the bigger things that can move this market and affect our positions of cash flow and capital gain for that matter. So that's why we listen to the Fed, that's a little bit about where it is.

They're long overdue, we've had a, they call this accommodative policy and for those of you who don't know what that means is they wanna make doing business much, much easier by providing access to money, they call it accommodative policy. Some people call it dovish policy and this is just a jargon you learn by hanging out in the financial circle. So it's been very accommodative since really since Allen Greenspan really and particularly with chairman Bernanke and chairman Yellen, especially Bernanke was the most accommodative policy that I've ever known we've given and so it's been going around so long that now we think, you know what? Well maybe it's time to get back to normal, get out of the hospital, get walking on our own and we'll see how it works out.

So the Fed isn't the force simply because, and the Fed has to feel some pressure I would think to get things back to normal because if you're at full tilt QE and you're at full tilt accommodative policy, where do you go from there if you need more? I guess you can always print more money but I think they feel pressure to get back to normal so that's it.

One final thought on the Fed, they're not supposed to watch the stock market, I think they do because so many peoples' 401k-s are tied to it but they claim that that's not one of their mandates is to prompt with the stock market but they seem to do anyway indirectly or however you wanna interpret that. But that's a little bit on the Fed and it's an interesting conversation, it's an interesting thing to learn more about. If you like to learn more about its history, read The Creature from Jackal Island by G. Edward Griffin, he's a wonderful storyteller, there's also an audio if you prefer that. I really like the audio coz he's a wonderful storyteller and he's a great historian and maybe we can get him on the podcast sometime if I had the chance to meet and greet and speak and being his circle somewhat, not a lot, but somewhat and so maybe we'll reach out to him and invite him on the show sometime.

But that's a little bit about the Federal Reserve. 1913 I think is when it came in to existence, don't quote me on that. But it is policy, we have fiscal policy, we have monetary policy, it's important to understand the monetary policy and next time I think we're gonna be speaking about the fiscal policy. So understanding those 2 policies and how they work together, big deal for investors that want cash flow out of stock markets, real estate markets, business markets and commodities and what have you.

So it's a little bit on the Fed, hope you enjoyed these comments and this review of where we are and what the policy says right now. Until next time, keep getting educated, keep building your cash flow and we'll see you next time.

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