

INTEREST RATE MOVEMENTS – SUPPLY AND DEMAND FOR MONEY

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In the financial media, one of the most frequently asked questions is, “when will the Federal Reserve (FED) raise interest rates?” Built into that question is the popular view that the FED sets interest rates and that interest rates affect the economy; i.e. lower rates stimulate the economy while higher rates slow the economy. At ICON, we don’t believe it is that simple. We believe it is the rate of growth of the money supply, called M1, that stimulates or slows the economy, and that interest rate movements are a byproduct of the supply and demand for money.

For Federal Reserve member banks, “reserves” can be defined as a bank’s currency holdings plus its deposits at the FED. These banks function with a regulated ratio limit of loans to reserves. For example, let’s say a bank is limited to a ratio of 10-to-1, meaning for every \$10.00 of loans on its books, the bank is required to have \$1.00 in reserves. Or, stated in the reverse, for every \$1.00 in reserves a bank holds it can have \$10.00 in loans. If a bank with \$10.00 of loans only has \$.95 of reserves, it can borrow a nickel of reserves from either the FED at the discount window or from other banks in the Federal Funds market. As an interest rate can be defined simply as the price to borrow money in the open market, the Federal Funds rate is determined by supply and demand for reserves among banks.

If the FED is trying to stimulate growth of M1 through open market operations, it will buy T-Bills from member banks and pay for them by adding to the bank’s deposits at the FED (reserves). With more reserves the bank can make more loans, and M1 grows. By buying T-Bills, the FED puts downward pressure on the interest rate for T-Bills, and by injecting reserves it puts downward pressure on the Federal Funds rate as the supply of reserves has increased. In this scenario we believe that even though the goal was to increase the rate of growth of M1, interest rates dropped as a by-product. On the other hand, if the FED wants to slow the rate of growth of M1, it sells T-Bills to banks who pay for them by having their deposits at the FED reduced. Rates on T-Bills rise and so does the Federal Funds rate as the supply of reserves has been reduced.

By historic standards, the reserve situation has been very unusual the last few years, with member banks holding far more reserves than normal. As reported in the June 29, 2015 issue of Barron’s, member banks held \$2,634,487 million (2.6 trillion) in reserves. However, they were required to be holding only \$146,114 million, meaning they were holding \$2,488,373 million more than required (often referred to as XS reserves). Further, currently only \$163 million has been borrowed from the FED. So, with a supply of about \$2,600,000 million and demand of only \$163 million, it is no wonder that the interest rate that results from the supply and demand amongst member banks is near zero. For the FED to put upward pressure on the Federal Funds rate and T-Bills, it would have to drain about \$2,600,000 million of

reserves from the system by flooding the market with T-Bills. We believe such a scenario seems improbable, and even unnecessary, as the FED has already accomplished what it wants – normal M1 growth.

Data as of June 29th, 2015

Total Reserves	\$2,634,487 million
Required Reserves	\$146,114 million
Excess Reserves	\$2,488,373 million
Borrowed reserves	\$163 million

The data quoted represents past performance, which is no guarantee of future results. Source: Barron’s

The graph below shows rolling 52-week rates of change in M1 from January 2004 through June 2015. From 1979 through early October 2008, just before the spike to 20%, the average 52 week rate of change over all rolling 52-week periods was about 4.8%. This graph shows almost zero growth in M1 from 2005 through 2008. We believe that during this time period the FED originally intended to prevent inflation from building in a strong economy. Further, we believe this unintentionally extended into 2008 as the FED did not realize the banking system was frozen and unable to lend. Then we saw a run up to about 20% year-over-year growth in M1 as the FED tried to jolt the economy out of recession with a policy of quantitative easing often referred to as QE1. Fearing inflation, the FED slowed the growth back to below 5% but soon realized the economy had not gained enough momentum and initiated a second round of quantitative easing, QE2, which increased the rate of growth back up over 20%. Gradually, the rate of growth in M1 has declined from its peak in early 2012. At the far right of the graph, for four weeks in a row through July 3, 2015, the 52-week rate of growth has been between 4.5% and 7.0%, closer to the pre-crisis average back to 1979. In other words, in terms of M1 growth, we believe we are currently in a more normal range.

M1 Rolling 52 Week Percentage Change, 1/2004 - 7/2015



The data quoted represents past performance, which is no guarantee of future results.

The return to M1 growth under 5% suggests to us that the FED believes the economy has enough momentum to continue growing without special monetary stimulus. It also leads us to believe those asking the question, "when will the FED raise rates?" might be missing the point. In our view, interest rates are determined by suppliers and borrowers who consider such things as inflation, economic growth, and opportunity cost. The FED has accomplished its goal of normal M1 growth and the yield on the 10-Year Treasury note has risen from its low of 1.64% on January 30 to 2.45%, back to where it was about a year ago. The Federal Funds rate and Treasury Bills have not moved. It seems to ICON that the FED has already accomplished a return to normal M1 growth and interest rates will go wherever they go based on supply and demand for money. To us, the question of "when will the FED raise rates?" seems irrelevant for investing. Rather than spending time trying to guess what the FED will do, we focus on value.

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M1 is one measure of the money supply that includes all coins, currency held by the public, traveler's checks, checking account balances, NOW accounts, automatic transfer service accounts, and balances in credit unions.

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