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Government policies have always had a significant impact on investors and investments, but the level of intervention in the economy and in financial markets has vastly increased in the last few years. This quarter's newsletter provides an analysis of the impacts of current policies on the economy and on financial markets in order to provided context to appropriate investment strategies.

Government Policies and Their Impact on Investing

Our clients save and invest so that they can consume at a later date when their income will otherwise be insufficient to support their desired consumption. We will focus on three areas of government policy that must be taken into account in savings and investment decisions: monetary policy, taxation policy, and benefit promises. Monetary policy affects future purchasing power and interest rates on investments. Taxation policy affects how much of investment earnings you keep, and through economic growth, investment returns. Benefit promises affect estimates of the portion of future consumption that the government will cover for us. Thus, all of these are crucial to an investment plan to fund future spending – i.e. retirement.

Monetary Policy and Inflation

The Federal Reserve Bank (the Fed) sets monetary policy. This means that the Fed determines the quantity of dollars issued and the interest rate paid to investors on government debt investments, and since 2008, also mortgages. In turn, interest rates and the supply of money impact general price inflation, housing and real estate values, interest rates (and values) of bonds and loans, stock returns, and the benefits of borrowing and lending.

The value of the dollar declines and prices inflate when the supply of dollars exceeds the amount people and banks are willing to hold as money (rather than investing or spending it on consumption). Beginning in 2008, the Fed has followed a policy called Quantitative Easing in which it expands the supply of money to lower interest rates and push inflation higher. The initial impact has been to drive up the prices of commodities (oil, metals, food, etc.) and financial assets. There has been muted transmission to wages and general prices so far. Thus the policy has served as a means to lower the real purchasing power of wages and shift resources from wage earners to the government (to pay for the higher level of deficit spending enacted in the 2009 stimulus bill) without raising visible taxes. Besides eroding the value of wages, inflation can also reduce the purchasing power of your savings and lower your future standard of living if your investments don't provide returns high enough to overcome the increases in prices. If inflation was constant at a fixed amount and we were in a more normal investing environment, it would be fairly straightforward to invest in a fixed income security such that your returns would exceed the inflation rate. Unfortunately, inflation is not a fixed amount. The huge buildup of excess money supply creates the potential for very large unexpected jumps in the inflation rate. Furthermore, as discussed later there are reasons to believe that very high levels of inflation might persist for a long time. This would destroy a large portion of the purchasing power of cash and long term bond holdings.

Federal Reserve Policy Effects on Housing and Real Estate

Until the last few years, most people viewed their homes as a solid investment and as protection against inflation in their largest budget item – shelter. The bubble and crash caused them to reassess that confidence. This is a good thing – to look critically at assumptions. In the long run housing follows the same laws of supply and demand as other goods in the economy. Its value is linked to incomes of its users – U.S. consumers. The linkage is via both rents and mortgage payments, which are tied to interest rates – now controlled by the Fed. The Fed has driven down mortgage interest and mortgage payments - to artificially lower the monthly cost of a given loan amount. The Fed is effectively subsidizing mortgage payments to push up house prices. Low interest rates combined with the availability of large quantities of foreclosed homes at reasonable prices, has caused institutional investors to put capital into housing to buy up and rent vacant properties. These factors have now started to push prices back up. Given the likelihood of increasing inflation we should expect to eventually see increasing mortgage rates when the Fed stops pouring money into the market. Now is probably the best opportunity for taking on a mortgage to buy a house that we'll see for a very long time. By doing so you can lock in a reasonable cost of shelter and reduce your inflation related risks. When the Fed eventually allows mortgage rates to rise, it will greatly reduce people's ability to afford houses. Sales volumes will decline, locking people in place. So choose wisely today.

The side effect of the Fed's intervention in favor of mortgage borrowers is that commercial real estate mortgages are also at very low rates. This, combined with the lingering discounts from the recent wave of foreclosures, make it an ideal time to buy investment properties such as apartments. (This is covered in the June 2012 newsletter). The attractiveness of these assets is reflected in the publicly traded securities of the Real Estate Investment Trusts (REITs) that trade on the stock exchange. These have already run up in price ahead of the private market.

Quantitative Easing Effects on Bond Prices and Yields

The Fed has pushed up the money supply by buying treasury bonds and mortgages. These purchases drive up the prices of these securities. Since the total cash flows are fixed, higher prices imply lower interest rates. This is what induces investors to sell to the Fed. But then they have cash with a 0 return so they look for some other fixed income security to buy. In turn, other bonds and loans are bid up in price and thus bid down in yield (interest rate). Ultimately interest rates available to investors end up low enough so that some of them are willing to hold the new cash created by the Fed rather than biding up other risky securities. In this way the Fed is reducing all interest rates in the economy.

What this has done for us as investors is bring forward to the present some of the returns we would have otherwise earned over time. This has provided us some help in producing incredibly high returns on our fixed income strategies. Berkeley Investment Advisors' Short Term income portfolio, which is primarily invested in corporate loans, is up an astounding 25.6% over the last 12 months. The Long Term income portfolio is slightly behind with a 23.8% gain over the last year. Sometime after mid-2015 the Fed will stop printing money and allow interest rates to rise. Before that happens bond investors will need to exit low yielding long maturity bonds to avoid losses. Because everyone cannot sell at the same time without causing a market crash, the prudent strategy is to keep maturities short or plan for an early exit well in advance of the Fed's moves.

Quantitative Easing Effects on Stock Investors

Equity market traders seem to interpret the Fed's moves as putting a floor under prices; thus encouraging traders to bid up prices. Lower interest rates can increase profitability at companies that borrow substantial amounts to fund their operations. But the biggest impact on equity investments is likely to come from higher inflation rates several years down the line. Although companies can benefit from inflation to an extent, by raising prices faster than worker pay, it also raises their tax rate because the tax code doesn't index capital costs for inflation. Also, because inflation distorts price signals it tends to cause misallocation of capital and therefore lower growth. So while equities do better than bonds in a rising inflation environment, it is still a negative for real (inflation adjusted) corporate earnings relative to a low inflation environment. This means that the impact on equities of Quantitative Easing is similar to its effect on bonds: returns are taken from the future and pushed into the present – meaning investors will bear greater risks for lower returns going forward. Since the impact in the equity market is mostly psychological, the psychology could change at any time and markets could revert to values more in line with current economic conditions and risks.

Quantitative Easing as an Income Transfer Mechanism

In terms of the big picture effects, by forcing interest rates to such low levels compared to inflation, the Fed is shifting economic resources from savers to borrowers. No doubt part of this shift is aimed at reducing the amount we must pay the foreigners (China) for our government's borrowing. But there are also large domestic transfers from savers to borrowers. The Fed's actions reduce the income of retirees and people close to retirement (if only the Fed would raise rates they could be retired) and shifts the resources to the banks and mortgage borrowers. There are also some negative consequences to taxpayers. For example, because government pension plans are generally underfunded, the reduction in interest rates increases the discounted value of their obligations more than it raises the value of their assets, thus exposing such large funding gaps that they cannot be ignored. These will need to be plugged by some combination of higher taxes, reductions in service levels, or cuts in future pensions. We see the effects of this in recent bankruptcy filings by the cities of Stockton and San Bernardino in California. Illinois may end up needing a federal bailout for their pension plan. If you are investing in uninsured municipal bonds you will need to pay attention to the finances of the borrower – especially their unfunded pension obligations.

Government Debt – The Big Downside

Now we turn to a complex but important topic: the interaction between interest rates, inflation, and government debt payments. Over the last few years the Fed has bought up a large portion of the new federal debt by creating new money to pay for it. In operation twist they bought longer maturity bonds so that the government's outstanding debt has been tilted towards short term debt. This is the equivalent of taking out a floating rate mortgage for your house right before interest rates go through the roof.

Currently federal debt held by the public is equal to 73% of gross domestic product (GDP). Total spending is 23.4% of GDP. Total taxes are 15.8% and the 2012 deficit was 7.6% of GDP. Because of the Fed's actions, interest on the debt is only 1.4% of GDP – which means the average rate is currently about 2%. This is extremely low by historical standards and is inconsistent with normal economic conditions. The average 1 year treasury rate since 1953 is 5.28%. Let's suppose rates went to 5.28%. That would increase the deficit from 7.6% to 10.4% of GDP. Borrowing 10.4% of GDP every year on top of the current debt (73% of GDP) would, within 5 years, bring us to the point where it becomes clear to all that we won't be able to pay it back.

As we see in Europe, when debt reaches the point where no one expects it to be paid, rates spike upward. But since spiking rates would cause recession, the Fed would ride to the rescue by buying up the debt with newly created money. This in turn would drive inflation higher. We saw such spiraling inflation in the late 1970's. Exactly 21 years ago, the 1 year Treasury bill rate was 16.52%. Back then we could absorb those costs because the overall debt was around 35% of GDP and, unlike today, much of the debt was longer term so that the overall average rate on government debt didn't go to 16.52% right away. If government interest costs reach 16.52% with debt at 73% of GDP, interest costs will absorb 12% of GDP –76% of current government revenues. At current tax levels that would give us a deficit of 18.2% - financed via money creation. The only possible results are either exponentially exploding prices or government default. Looking to recent examples in other countries: Greece defaulted this year, Argentina defaulted in 2001, and Russia defaulted in 1998. Brazil and Yugoslavia chose hyperinflation in the 80's and 90's.

There is still time for the government to avoid the scenario above by cutting the deficit. In fact current law will rein in the deficit in 2013 by raising taxes and huge cuts in government spending. Maybe it will happen. Just in case the worst case comes to pass, investors need to hold assets that will rise with inflation – such as gold, resource companies, or real estate.

Tax Policy

Under current law, there will be significant increases in taxes in 2013. Unless congress acts to change the law, higher tax rates in 2013 will reduce economic activity. We cannot easily predict how this will impact investments because we don't know to what extent this well advertised tax increase would be a "surprise" to market participants. In the long run, higher taxes that yield lower government deficits and lower growth will tend to favor bond investors over stock investors.

If congress does not act to extend current tax rates before adjourning for Christmas, people who expect high income in retirement should consider converting a portion of regular IRA accounts to Roth IRA accounts before year end. The only reason to do this would be if you expect your tax rate to be higher at retirement than it is in 2012. When making such calculations, I recommend using the 2013 brackets as a good approximation for the future rates. Note that the new ObamaCare 3.8% tax surcharge on investment income does not apply to retirement account distributions so you can ignore this in your Roth conversion analysis. Investors should also consider realizing taxable account capital gains in 2012 on positions that they are comfortable selling; taxes on such gains will go up substantially in 2013 under current law – especially if the ObamaCare surcharge will apply to you.

Benefit Promises

The social security program is not a funded retirement system like a 401K or a private pension plan that has assets to draw upon for retirement distributions. Social security is purely a transfer from current taxpayers to current retirees. This system was designed at a time when life spans and years in retirement were much lower than today. Thus the tax burden on the working generation has always been tolerable. As the Baby Boom generation retires and the ratio of retirees to working taxpayers rises, so must taxes. Similarly Medicare spending is rising rapidly relative to working taxpayer incomes both because of longer life spans of retirees and because medical cost per person is growing much faster than incomes. Current government benefit promises can only be honored if the working age population is willing to pay much higher taxes than any generation before. This may well happen, but it's also possible that the younger generation forces politicians to scale back the promises. Therefore, the prudent thing to do is plan for the possible benefit reductions. If reductions don't happen, you'll have more money left over to leave to your kids - in which case they'll need it to cover their higher tax bills.

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