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The Federal Reserve: Can It Do Much More?

Since assuming the Federal Reserve's chairmanship in 2006, Ben Bernanke has presided over the most severe financial and economic crisis since the Great Depression. He has used more tools — both conventional and unconventional — to try to prevent the collapse of the American and global financial systems and revive a weakened U.S. economy than any chairman before him.

Now, with short-term interest rates near zero and the economy still languishing with weak growth and stubbornly high unemployment, the question is whether Bernanke has any tools left — within the bounds of the Fed's mandate — that can change the economic status quo.

The Fed's Charter

The Federal Reserve was created by an act of Congress in 1913. As detailed in the 1978 amendment to the Federal Reserve Act, the Fed's goals when setting monetary policy are "to promote maximum sustainable output and employment and to promote stable prices."

Its primary tools for doing that are setting reserve requirements for nationally chartered banks; setting the rate for overnight loans to member banks to meet daily reserve requirements; and through its Federal Open Market Committee, trading debt securities — generally U.S. Treasuries — to try to influence the interest rate that member banks charge each other for overnight loans.

When it comes to managing the economy, the Fed relies on its ability to influence interest rates. When the economy begins to grow too fast and inflation moves to levels that endanger the purchasing power of the

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Dating the Business Cycle

The business cycle refers to the cycle of economic activity — periods of expansion followed by periods of contraction or recession. While the term business cycle implies that these periods occur with some regularity, they actually occur at irregular intervals and last for varying periods. Business cycles are dated based on when economic activity changes direction. The National Bureau of Economic Research (NBER), a private, nonprofit research organization, determines the official dates of peaks and troughs in U.S. business cycles. However, its actions seem to focus more on accuracy than speed, taking anywhere from six to 18 months to assign a date.

A popular definition of a recession is a period when real gross domestic product (GDP) declines for at least two consecutive quarters. However, since the NBER dates peaks and troughs by months instead of quarters, it does not rely solely on GDP. While the NBER uses many factors in its analysis, some of the more significant factors include real GDP measured on the product and income sides, economy-wide employment, real income, and to a lesser extent, industrial production and wholesale/retail sales. Before announcing a peak date, the NBER makes sure that the decline is large enough to qualify for a recession, which can take several months. Before announcing a trough date, the NBER makes sure that the rise is sustained and does not start to decline.

With regard to current economic conditions, the NBER determined that the recent recession started in December 2007 and ended in June 2009, which means it lasted 18 months. The announcement of the end of the recession was made in September 2010. Based on the length and strength of the recovery to that time, the NBER decided that any further downturn in the economy would be a new recession and not a continuation of the latest recession. ❍❍❍

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The Federal Reserve

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dollar, the Fed raises interest rates. This curbs borrowing and demand, which slows down the economy. Conversely, when the economy is weak, the Fed lowers interest rates to try to encourage more spending through increased borrowing, while discouraging saving in favor of investments in stocks.

The 2008 Financial System Meltdown

In September 2008, the collapse of the once-venerable investment bank Lehman Brothers triggered a global banking panic. The cause was trillions of dollars in mortgage-backed securities that turned out to be backed by low-quality mortgages in spite of triple-A credit ratings. The shock to the market lay in the fact that the U.S. government didn't bail out Lehman Brothers as it had Bear Stearns six months earlier.

Banks around the world had invested heavily in risky derivatives, and their ability to borrow and lend money was crippled by the fact that the market for such securities had effectively shut down over fears they were all worthless.

Under Bernanke's leadership, from 2007 through 2009, the Fed deployed an array of both conventional and unconventional tools. In addition to lowering interest rates, it made unprecedented purchases of mortgage-backed securities and became the lender of last resort — not just to Fed member banks but to insurance companies like AIG.

The Fed also engaged in the brokering of troubled Wall Street firms like Merrill Lynch and Bear Stearns to be purchased by stronger financial firms and assisting foreign-owned banks, both for operations in the United States and Europe.

Economic Stimulus

The collapse of the mortgage-backed securities market coincided with the bursting of the real estate market bubble, which it had largely created. Together, they triggered a deflationary spiral involving mortgage foreclosures, a sharp decline in bank lending, layoffs, and the Great Recession.

So by 2010, the Fed shifted its focus from trying to keep the global financial system intact to fighting deflation and reviving the economy.

Following its conventional agenda, the Fed brought the overnight discount rate and federal funds rates to near zero; in real terms, dragging the rates down on short-term Treasuries. In an attempt to reduce rates on longer-term Treasuries, it launched two rounds of "Quantitative Easing" — the purchase of more than $2 trillion in Treasury bonds.

In 2011, the Fed launched "Operation Twist," aimed at bringing the rates on the longest maturities — 15 to 30 years — down to spur long-term capital investments and curb fears that all the money it had injected in to the economy would reignite high rates of inflation.

Internal Fed studies show that these programs may have cut interest rates by more than one-half of a percentage point and saved as many as three million jobs.

In September 2012, the Fed announced "Quantitative Easing 3," pledging to purchase $40 billion of mortgage-backed securities per month. It also maintained "Operation Twist" and pledged to keep interest rates low through mid-2015.

Where We Are Today

In spite of all the Fed has done, the economy remains weak. Fed watchers say Bernanke may be all out of ammunition, or at least out of the firepower to significantly change the economic status quo.

The problem, they say, is that the economy is caught in a "liquidity trap" in which businesses and banks are sitting on trillions of dollars in idle cash but are unwilling to use it. Banks are reluctant to lend and businesses are reluctant to borrow or to hire. Some economists say that's because there isn't sufficient demand to make spending profitable, while others say business is stymied by excessive regulations and the prospects of having to cope with federal health insurance laws. Whatever the case, with interest rates at record lows and huge piles of idle cash lying around, there's the growing perception that any further Fed actions won't make much difference.

Observers speculate that Bernanke might do something more creative, such as reduce the interest that the Fed pays member banks on the excess reserves they hold on deposit at the Fed. Since 2008, the Fed has been paying 0.25% on those reserves, said to total $1.5 trillion. The idea is that since banks can borrow from depositors at even lower rates, keeping those reserves at the Fed is risk-free money and, thus, more attractive than even making a loan at 3%. By lowering the interest it pays on member bank reserves, the Fed diminishes profit on the deposits and nudges banks to make loans.

In testimony before Congress and speeches before the press, Bernanke has said repeatedly that monetary policy has just about run its course and that only fiscal stimulus — government spending — can have a real effect on the economy. With Congress sharply divided on whether additional stimulus would improve the economy or make it worse, it's unlikely that its deadlock will be resolved soon. ❍❍❍

Review Your Homeowners Insurance

Often, homeowners insurance is purchased with the home and then is not thought about again until a claim is made. But since there is little you can do at that point about your coverage, take time periodically to review your policy. Some items to consider include:

❍ **Review the adequacy of your policy limits.** Investigate how much it would cost to replace your home and make sure your policy limit will cover that amount. Don't insure your home for its market value — it may cost more or less than that to rebuild it. And even if your home was totally destroyed, you would still have the land. Try to obtain guaranteed replacement cost coverage, where the insurance company will rebuild your home even when the cost exceeds the policy limits. Make sure your policy has an inflation endorsement that increases your coverage annually for increases in construction costs.

❍ **Obtain coverage for special risks.** Basic policies protect you from fire, smoke, windstorms, vandalism, and lightning. The most comprehensive policies cover every peril except those specifically excluded, typically floods, earthquakes, war, and nuclear accidents. If you live near a flood plane or earthquake area, obtain specific coverage for these perils.

❍ **Understand what other items are covered by your policy.** Your homeowners policy also typically covers personal property, other structures on your property, landscaping, loss of use when your property is destroyed, and personal liability coverage. Carefully review the limits for all of these items, since you can generally add endorsements if you need additional coverage. Typical policies cover personal property for a maximum of 50% of the coverage on the home, usually paying actual cash value, which deducts depreciation from the amount paid. Try to obtain a replacement cost endorsement, which pays to replace your property and typically raises the limit to 70% of your home's coverage.

How to Reduce Premiums

While you do not want to skimp on your homeowners insurance coverage, it is possible to obtain appropriate coverage and save money at the same time. Consider the following tips:

❍ Utilize safety features in your home, such as fire alarms, carbon monoxide detectors, motion sensors, and security systems.

❍ Increase your deductible, which can lower your premium.

❍ Ask about discounts for using the same insurance company for other insurance needs.

❍ Stay with the same company. Insurance companies will often give loyalty discounts to customers.

❍ Maintain a smoke-free environment. Insurance companies will often lower premiums for households that are smoke free. ❍❍❍

Control Your Spending

If you're trying to increase savings, remember that savings are directly tied to spending — the less you spend, the more you have to save. Some tips include:

❍ **Analyze your spending for a month.** Give serious thought to your purchasing patterns, looking for ways to reduce spending. You may scoff at some ideas for saving money, thinking you can't possibly add much to your savings. But over a long time period, even modest amounts can grow to significant sums.

❍ **Go over major expenditures also.** When was the last time you comparison shopped your auto or homeowners insurance? Have you checked mortgage rates lately? Have you reviewed strategies to reduce your income taxes?

❍ **Make a spending plan and put it in writing.** Budget for all major expenditures.

❍ **Throw out your credit cards (or at least hide them for a while).** Most people find it more difficult to spend cash than to charge a purchase. So, for the next couple of months, only purchase items with cash.

❍ **Don't purchase items over a fairly low dollar amount until your second shopping trip.** How often have you purchased something on impulse, only to realize when you got home that you really didn't need it? To control those impulses, compare price and value on your first shopping trip. Then go home, think about whether you really need the item, and purchase it on another trip.

❍ **Think carefully before making major purchases.** Often, upkeep and maintenance will add to your costs. Consider a less-expensive car or a used car. Keep your car for four or five years instead of getting a new one every two or three.

❍ **Figure out the maximum amount you can afford for a house and then buy one substantially less expensive than that.** Not only will you save on your mortgage payment, other costs associated with owning a home will be lower. Living well within your means is one of the best ways to ensure you have money left over for saving. ❍❍❍

How Much Do You Need for Retirement?

Retirement remains the number one concern among working Americans, and the number-one question is, "How much money will I need to retire?"

Unfortunately, there's no easy answer, since there are many variables to consider before you find that number. First among them is how much your lifestyle in retirement is going to cost. Other variables you'll have to pin down include what your health will be like, how much more expensive things will be, what your tax rate will be, and so forth.

The truth is, however, that even after your plan is done, your number will always be a moving target as conditions in the economy, financial markets, and your life change. Uncertainty is greatest the farther away from retirement you are; but once you reach retirement, even the best of plans needs to be revisited about once a year.

Here are the steps involved in preparing a personalized retirement plan:

Step 1: Identify your retirement goals. How much will the retirement lifestyle you want cost? When do you want to retire? At this point, it's okay to dream. Give the numbers a run — the financial planning process usually tosses out unrealistic expectations fairly quickly.

When it comes to pricing your future lifestyle, it's best to base it on your current lifestyle. If you don't know what that costs, you need to create a budget that line-by-line accounts for monthly expenses in all categories. Multiply those monthly expenses by 12, and take that number as a good benchmark for how much you'll need to spend in retirement.

Then you can adjust that number up or down — down for expenses you may no longer have, like mortgage payments or the cost of commuting to work; or up for things you'd like to have or do, like travel more or maintain a vacation home. A rule of thumb that works for many for planning purposes is 70% to 80% of your current household income.

Step 2: Identify your known income streams. Start with a projection for Social Security. Don't know what it is? Go to the SSA's website (ssa.gov) and use their "Retirement Estimator" to estimate your monthly check for yourself and partner, then annualize that number. Next, add any annual cash streams you might get, such as from a pension plan, rents, royalties, or trust funds.

Step 3: Calculate your income gap. Subtract your combined retirement income stream total (Step 2) from your annual retirement lifestyle cost (Step 1). The difference is how much you have to make up with withdrawals from your nest egg: taxable savings and investments, IRAs, and annuities.

Step 4: Calculate the nest egg you'll need. Divide any negative income gap by 4%. The result gives you a rough idea of how much in personal liquid assets, in today's dollars, you need to accumulate in order to afford to retire. Why divide by 4%? Because that's the approximate rate of annual withdrawal you should take from your retirement savings to make your money last for as long as you live.

Determining how much you need to accumulate in savings is just the first step in drawing up a retirement plan. The next step is to compare that to how much you've already accumulated and determine what you need to do to accumulate the rest. It could mean adjusting how much you save per year, how you invest your money, or changing the year you retire.

If you're uncertain about how much you need to retire or whether you can reach that amount, you owe it to yourself to create or revisit your retirement plan. Please call if you'd like to discuss this in more detail. ❍❍❍

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Did You Know?

The gap between men and women in knowledge and awareness of personal finances is growing, according to a recent survey. Just 66% of women said they had general knowedge regarding stocks, bonds, and mutual funds versus 89% of men. Only 34% of women understood the tax implications of their investment strategies versus 56% of men. From a financial planning standpoint, fewer women than men had a handle on how much they are spending each month (62% versus 78%).

Only 52% of women were comfortable with their level of nonmortgage debt versus 71% of men (Source: *AAII Journal*, July 2012).

Approximately 90% of women will be solely responsible for their finances at some point during their lives due to the death of a spouse or a divorce (Source: *Financial Finesse*, 2012).

Those who have recently retired should resist the temptation to pull out of stocks when market conditions turn turbulent. Doing so eliminates the growth component of a portfolio and could increase the likelihood of running out of money from 20%–30% to more than 90% (Source: *T. Rowe Price Insights*, 2012).

Approximately 31% of ultra-high-net-worth investors age 40 or younger feel that they aren't saving enough for retirement and other financial goals (Source: Spectrem Group, 2012). ❍❍❍