WINTHROP Capital Management

The Role of the Federal Reserve in Today's Capital Markets

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The Federal Reserve

The Federal Reserve was established in 1913 as the U.S. government's central bank. The Federal Reserve, known by its short name – the Fed, does basically three things:

1. Provides regulatory oversight to banks
2. Works to keep the banking and financial system sound
3. Contributes to the long-run growth of the economy by maintaining price stability and full employment

The form and function of the Federal Reserve has stayed much the same since 1935. However, the growth in complexity of different securities in our capital markets as well as the growth of financial institutions such as hedge funds has challenged the traditional role of the Fed.

Treasury Secretary Henry Paulson has put forth a plan to expand the role of the Federal Reserve and consolidate the patchwork system of financial regulators that have proven ineffective given the recent market turmoil. Paulson's vision would give the Fed broad powers so they could make initiatives anywhere in the financial system where they need to. Unfortunately, with an election this November, we believe his proposals will not be given complete consideration.

Monetary Policy & the Role of the Federal Reserve

If monetary policy is the only tool the Fed has to impact economic growth, can the Fed be effective?

Controlling price stability is another way of saying "keeping inflation under control." In our complex financial system, the Fed attempts to control the rate of inflation though changing the money supply in our system. The Fed can do this in a number of different ways; however the method most publicized is the changing of short term interest rates known as the Fed Funds rate. The lower the Fed Funds rate, the cheaper it is to borrow and lend resulting in a higher rate of investment and business formation.

In an effort to stimulate the economy and lubricate the gears of the financial system, the Fed has pumped more money into the financial system. In the past seven months, the Fed has aggressively lowered short term interest rates by 3.25%. After the most recent 25 basis point reduction and the Fed Funds rate settling in at 2.0%, this represents one of the most aggressive rate cutting campaigns ever.

The major concern with the Fed's initiatives is that stimulating the economy will result in the potential for an increase in the rate of inflation. With the most recent cut in the Fed Funds rate, the Fed has clearly sacrificed price stability for economic and financial market stability. The most recent statement from The Fed indicates that, while the economy remains under stress, they will likely pause in the rate cutting program to see the impact of their initiatives. In addition, the $110 billion of tax rebate checks arriving in the mail this month will help to stimulate economic growth.

Is the Federal Reserve Still Relevant?

The short answer is yes. By lowering short term interest rates 300 basis points over the past two months, it is hoping to stimulate economic growth by lowering borrowing costs. However, that hasn't been enough to restore liquidity to the financial markets. In order to relieve pressure on banks and broker-dealers to move illiquid mortgage-backed securities off of their balance sheets, the Fed created the *Term Auction Facility* (TAF) and the *Term Securities Lending Facility* (TSLF). These facilities are designed to allow banks and broker-dealers the ability to lend their illiquid mortgage-backed securities in exchange for U.S. Treasury securities. The result is less pressure in the market to sell these illiquid securities and hopefully a more orderly, functioning capital market.

The regulation of our financial markets is a complex patchwork of state, national and self-regulated entities. The Fed has regulatory authority over nationally chartered banks. The important initiative that was set by creating the TSLF is that it is directed at broker-dealers, which the Fed only has loose regulatory control over.

Investor confidence is an important aspect of a well functioning financial market. The widespread concern of an insolvency of any major bank, broker-dealer or hedge fund can lead to a domino effect in which investors pull their money and the financial system implodes as a result. In its role of maintaining investor confidence, the Fed has helped to arrange several transactions designed to minimize the financial the turmoil in the market. The Fed helped to prop up our financial system again in 1998 when it orchestrated the bail out of the overly leveraged hedge fund, Long Term Capital Management. The coordinated bail out of Long Term Capital Management created a new template for Wall Street and government to work together to minimize the impact of financial firm failing. This model would be implemented again in 2007 with the orchestrated sale of the assets of the hedge fund Amaranth.

The merger of Bear Stearns into JP Morgan Chase last month is the most recent example of the Fed helping to provide the resources to avoid the failure of a major financial institution. The U.S. financial system is facing a severe liquidity challenge not a solvency crisis. In essence this means that banks and broker-dealers are less willing to lend money. As a result, the Federal Reserve is stepping in and playing its role as "the lender of last resort".

Gregory J. Hahn, CFA
President & CIO

Stephen P. Carr, CFA
Portfolio Manager