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The Fed's Dual Mandate: Truly an Impossible Task

Current market conditions face strong headwinds from several sources including the war in Europe, the pandemic, and last but not least Fed action. I'd like to focus my attention on the Fed to explain what they're trying to do, why they're trying to do it, and why their dual mandate charge has little or no chance of success.

Fed action has a direct impact on any investment strategy. Based on my academic work combined with observing the Fed over the past several decades, I am convinced that a basic understanding of the Fed is an important factor affecting portfolio construction. The US Fed is, in my opinion, one of the most powerful institutions in the world, in some ways even more powerful than the US Presidency. For this reason, a fundamental understanding of that power is important. As powerful as it is, the Fed is far from infallible. Milton Freidman, Nobel Prize laureate, was quite critical of the Fed due to its poor performance and felt it should be abolished. Since that is highly unlikely, we need to understand the limits of Fed power and how to construct a portfolio that reflect those limits.

The Dual Mandate. Below is the Fed's charge as stated in its charter. A careful reading of this charge reflects what is called the Fed's "dual mandate"; a mandate to simultaneously contain inflation while providing for full employment. This dual mandate has never been achieved for any length of time because it contains conflicting goals. Containing inflation requires raising interest rates while providing for full employment requires lowering interest rates.

> ***Section 2A of the Federal Reserve Act***. *The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.*

Inflation. Jay Powell, the Fed's Chairman, has said he would address the historically high inflation by raising interest rates multiple times over the next 12 months but not so aggressively as to harm the economy, a strategy commonly referred to as a "soft landing". After two years of a major shock caused by the pandemic, the economy has recently been showing signs of a strong recovery and Mr. Powell does not want to interfere with that recovery. This goldilocks "soft landing" scenario suggests the Fed has the skill to exert financial constraints at precisely the right time in exactly the correct amount. History says all these bright, highly educated people at the Fed are fighting a losing battle for several reasons.

The most formidable problem facing the Fed is simply measuring inflation. Using historical data several months old to gauge current inflation is like predicting the weather for tomorrow based on what it was 2 or 3 months ago. The Fed well understands this problem and, consequently, relies more on measuring inflationary expectations as reflected in the current price of TIPS, which are inflation protected bonds. TIPS are government-issued bonds indexed to inflation.

When inflation rises, TIPS adjust the face value of the bond upward by the increase in inflation, a process designed to maintain the bond's real (inflation adjusted) value.

TIPS can give some idea of future inflation assuming expectations accurately capture future inflation. Although TIPS are important, they fail to address whether the expected inflation is short-term or long-term, temporary or permanent, widespread across all consumer goods, or contained in only a few commodities like the cost of energy. The *Economist Magazine* says the higher cost of energy is temporary and, thus, the Fed should ignore it. An even deeper issue is whether inflation is coming from too much money in circulation because of the enormous federal deficit and freely printing of dollars, which is what Freidman would say, or is being generated from supply chain problems over which the Fed has no control? Nobody has definitive answers to these troubling questions.

Full employment. The second charge—that of maintain full employment-- also contains significant problems; the most basic of which is accurately measuring full employment. Not only is the lack of timely data a major obstacle, but the methodology for using that data is challenging. The Fed's methodology defines the employment rate as the percentage of potentially employed people who have jobs and the unemployment rate as the share of workers in the labor force who do not currently have a job but are actively looking for work.

These two definitions are suspect. The unemployment rate may rise or fall by changes in the work force. When workers become discouraged and stop looking for work, they leave the labor force, which is a common occurrence during a recession. Conversely, the unemployment rate may fall during an economic recovery due to the number of workers seeking employment, which can cause the unemployment rate to persist. A final problem is the employment rate can include underemployed workers who have taken jobs below their skill or experience level. An example of underemployment is a highly educated scientist driving a taxi just to pay basic living expenses.

For the above reasons, I do not rely on the Fed's action in helping me make important investment decisions on your behave but, instead, focus on your risk tolerance. My strategy is to link your risk tolerance with appropriate financial securities available in the market in order to create a diversified portfolio of financial assets that meets your specific objectives. If your risk tolerance allows taking above average risk, I tilt the portfolio toward growth assets (equities). For clients who need income (less risk), I tilt the portfolio toward income-generating assets like bonds, real estate, and high-quality dividend-paying equities. Exchange Traded Funds (ETFs) are excellent for achieving diversification across multiple classes as well as within each asset class. I believe gauging your risk tolerance, which is an internal factor over which you and I have control, is infinitely more important than relying on an external factor such as the Fed's action over which I have no control and little confidence. I trust the US economic resilience much more than the Fed's ability to manage a very complex financial landscape.

Conclusion. My hope is that this brief essay gives you a better understanding of the strategy I employ when making important investment decisions on your behalf. My approach to portfolio construction depends heavily on your keeping me informed as to changes in your life that affect your risk tolerance such as changes in your health, changes in your employment, and changes in your familial situation. Please let me know if you have any questions or concerns about this essay. In closing, I may add that my partner, Justin Burgess (JB), fully understands my model and is quite capable of employing it if something were to happen to me. All the best, REC