

**How long can the federal funds rate stay so low?** The Federal Reserve has publicly stated that it will keep the federal funds rate between 0% and 0.25% for an “extended period”. Many economists don’t see the Fed raising rates until well into 2010. Yet rates will move north someday. How soon might that happen? And how could the Fed delicately move rates north without hampering the recovery?

**The *Barron’s* argument.** On October 19, *Barron’s* published a piece titled “G’mon, Ben!” in which senior editor Andrew Bary called for short-term interest rates of 2.0%. Why? “Super-low short rates are fueling financial speculation, angering our economic partners and foreign creditors, and potentially stoking inflation.” One concern is that by keeping rates so low for so long, the Fed might risk an asset bubble – recall how the housing bubble was aided by low interest rates. The article called for the Fed to exit the crisis mode policy of the last 12-18 months.

What would raising short-term interest rates to 2% possibly accomplish? Well, the tactic could prove a decisive and wise move to control inflation (CPI is on track to come in at 2% for 2009, so Bary argues that inflation is indeed back) and aid the dollar.<sup>2</sup> The downside, of course, is that the move would amount to a right cross to the jaw for the stock market (and possibly the commodities markets)..

**The challenge for the Fed.** The stock market is having a great year; the economy is not, with unemployment currently around 10% and the business and real estate sectors taking a long time to recover. Given this, most economists and market analysts see no incentive for the Fed to make a move. (In fact, St. Louis Fed President James Bullard has cited “jobs growth and unemployment coming down” as a “prerequisite” for increasing interest rates.)<sup>3</sup> The challenge for the Fed is how to signal or hint at a move in the coming quarters in a way that seems reasonable or non-disruptive to the recovery.

There are possible hints of inflation here and abroad (renewed strength in emerging market economies, gold prices soaring and the dollar hurting). On October 22, Philadelphia Fed President Charles Plosser told Bloomberg Radio that he felt the time to raise rates would come sooner than most Fed officials believed. The next day, a Bloomberg data survey showed that traders had increased the probability of a federal funds rate hike in 1Q 2010 to 48% from 37% the day before.<sup>4</sup>

**The prevailing notion.** TheStreet.com published a rebuttal of sorts to the Barron's article – a piece titled “It's Absolutely Not Time to Raise Rates, Ben!” in which author Ron Insana argued that the recovery was too fragile to prompt any notion of raising the federal funds rate. Many analysts feel that a rate increase is simply unwarranted without a demonstrably healthier job market, housing market and banking system.

Out west, San Francisco Fed President Janet Yellen told reporters that she didn't anticipate a rate increase or any tightening of the Fed's rescue programs in the next several months.<sup>5</sup> So the question remains “when” – and the Fed must move as carefully as ever.

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**Citations.**

<sup>1</sup> [online.barrons.com/article/SB125573856421291217.html?mod=BOL\\_hpp\\_highlight](http://online.barrons.com/article/SB125573856421291217.html?mod=BOL_hpp_highlight) [10/19/09]

<sup>2</sup> [theglobeandmail.com/globe-investor/investment-ideas/should-the-fed-raise-interest-rates/article1332498/](http://theglobeandmail.com/globe-investor/investment-ideas/should-the-fed-raise-interest-rates/article1332498/) [10/23/09]

<sup>3</sup> [bloomberg.com/apps/news?pid=20601103&sid=aTZcPQocptNo](http://bloomberg.com/apps/news?pid=20601103&sid=aTZcPQocptNo) [10/12/09]

<sup>4</sup> [bloomberg.com/apps/news?pid=20601100&sid=a7TCuN67vo9U](http://bloomberg.com/apps/news?pid=20601100&sid=a7TCuN67vo9U) [10/23/09]

<sup>5</sup> [reuters.com/article/pressReleasesMolt/idUSTRE59J6C720091021](http://reuters.com/article/pressReleasesMolt/idUSTRE59J6C720091021) [10/21/09]