

December 2015

## Hamilton's Duel-Over

*As Janet Yellen stops contemplating and goes about raising interest rates a tiny bit we are reminded of the "Last Shot" scene in the Broadway sensation "Hamilton." With a careful hand on the rudder of global finance instead of a flintlock, Ms. Yellen has been calculating potential consequences of her actions (or inaction) and, hopefully unlike Alex, keeps some financial powder dry while hitting her target. Before discussing the predicament facing the Federal Reserve, let's review some history of our nation's first Treasury Secretary.*

### Break-A-Leg

Ron Chernow's 2004 treatise on Alexander Hamilton has caused this founding father's *historic* stock to rise – to Broadway, no less. Some of our readers know that Hamilton College in Clinton, New York, received permission to use his name on their newly chartered school over 200 years ago. Unfortunately he never visited thanks to his untimely collision with a bullet fired by then Vice President Aaron Burr on July 11, 1804 in Weehawken, New Jersey. Although no one knows for sure what happened the morning of the duel, it is widely assumed that Hamilton honorably "deloped" – the French word for purposely throwing away one's shot by aiming upward – while Burr took dead aim.

Hamilton accomplished more in his short lifetime than can be imagined. He is credited with having written at least 40,000 pages (with an ink-tipped feather) covering subjects such as taxes, treaties, slavery (anti), liberty, as well as vitriol for the King of England and his own political opponents. Hamilton started the federal banking system, the Coast Guard, the Federal Mint, wrote more than one half of the Federalist Papers and founded the Bank of New York. George Washington relied on him heavily, reminiscent of the relationship that Dick Cheney is assumed to have had with George W. Bush. Incidentally, unlike Burr, Vice President Cheney *accidentally* shot people...but, we digress.

### Delope-a-Dope

As a segue to today's Federal Reserve policy, it is important to note that Hamilton was a Federalist who believed in a strong central government. As we noted in a previous newsletter, Hamilton was quoted as saying, "A national debt, if not excessive, will be to us a national blessing." While we have no idea what he would think of today's circumstances, we have documented in numerous newsletters our feeling that our financial system has not put the 2008 financial crisis fully behind us, as the national debt has since climbed by nearly \$10 trillion<sup>1</sup>. Moreover, our Federal debt is projected to rise substantially over the next decade (and longer) but will remain "stealth debt" – so long as interest rates remain unusually low and no one really "pays" for the debt.

Janet Yellen, meanwhile, is in a tough spot. The other developed economies of Japan and Europe have seen their currencies devalued relative to the dollar – mostly by design, in order to boost their economies – at the expense of US exporters in many cases. Europe has been so desperate to keep interest rates low (thereby weakening their currency) that they actually started *receiving* interest on deposits instead of paying – so bank customers essentially pay to deposit Euros in the bank. These negative interest rates, and continued quantitative easing in Japan and Europe (we stopped

1) Based on total debt outstanding per U.S. Treasury publications.

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ours after the Fed accumulated \$4.5 trillion in assets) are a sure sign that some basic economic principles, like the time value of money, have been suspended by fiat, and not by natural laws of commerce.

### Watch Out For a Ricochet

Ms. Yellen did act this week to increase the federal funds rate for the first time since 2006. Though inflation remains low, she sees that employment is strong by some measures and wages are finally growing. In addition, Yellen is surely wary of market distortions that befall a policy of keeping interest rates so low for so long. For example, low interest rates stimulate employment in the housing and automotive industries, but cheap money likewise encourages companies to borrow to make acquisitions, invariably leading to the loss of thousands of good jobs.

As cases in point, Hamilton Point clients have had two of our Equity Income holdings, **Heinz** and **Kraft** acquired by Warren Buffet in recent years at premiums of about 20% and 35%, respectively<sup>2</sup>. Mr Buffet's handiwork has lined our clients' pockets handsomely as his corporations borrowed money at around 2% (thereby reducing the corporate taxes they pay) in order to combine operations and fire thousands of employees, so that his investors could potentially benefit. Thus, super-low interest rates create both positive and negative feedback loops.

Also concerning is the influence of the dollar's strength on foreign currencies in the Fed's calculations. Because America remains the world's strongest democracy (i.e. military, finance, technology, rule of law) and since other nations are trashing their currencies with devaluations and negative interest rates, our dollar has surged in value. Our strong dollar hurts our export competitiveness but allows us to import deflation—two things that will be exacerbated if rates are further increased. In other words, this strengthening in the dollar theoretically argues against continued rate increases in the near term.

2) For a free list of all recommendations made by Hamilton Point during the last year, please contact us.

### Not Giving Up Her Shot

At Hamilton Point we invest with a long-term horizon and do not overly concern ourselves with small movements in interest rates when positioning portfolios. Just the same, we do think that recent turbulence is proving once again that bond and equity investments of high quality are the best for riding through tough markets.

Given the foregoing though, we do see at least one compelling reason for the Fed's increase in interest rates and that is, strangely enough, so that they can reduce them again if needed. They need to create some "dry powder" in case the economy takes another stumble, and surely they would rather not go the route of negative interest rates as is the standard in Europe currently.

We can almost hear Janet Yellen rapping a refrain from the Hamilton musical "I am not throwing away my shot!" as she walks the halls of the Fed. We do not envy her as she attempts to re-arm the Fed, any more than someone would have Alexander Hamilton that morning in Weehawken. Surely she does not want to have regrets, like Hamilton presumably did, about giving away a last shot, leaving no option for a do-over.

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