What has this got to do with the Price of Cheese?

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Lower consumption of cheese in 2016 caused inventories to increase. Producers responded by cutting prices. This action had the desired result. Consumers, enticed by lower prices, bought more cheese and inventories fell back to normalized levels. In fact, the increased demand for cheese at lower prices caused milk prices to go up. This dynamic interaction between supply and demand for cheese and milk all took place in an orderly fashion without interference from the "Federal Cheese Reserve."

In a free market for capital, borrowers and lenders agree on price in response to the forces of supply and demand. Interest rates reflect the price or cost of capital. When there is excess demand for capital, interest rates rise and vice versa when demand dries up.

Unfortunately, in our capital markets, a big gorilla in the form of the Federal Reserve Bank interposes itself under the false assumption that we need a hairy and invisible hand to help us regulate the supply and demand of capital, so as to avoid excess inflation and unacceptable levels of unemployment. They make it sound ever so reasonable.

Evidently, we can be trusted to operate cheese exchanges, but when it comes to capital exchanges, we had better defer to the Fed. After all, one of the biggest players in the capital markets is the government, a menacing accumulator of enormous debt. It is no coincidence that with the help of the Fed, we had record low interest rates during a period of fifteen years when the national debt ballooned from $5 trillion to $20 trillion. If we did not know any better, we might argue that taxpayers, responsible for the servicing of this debt burden, owe the Fed a token of gratitude.

March 15, 2017, the Fed raised its target for the federal-funds rate by 25 basis points to a range of 0.75% to 1.00%. The S&P 500 surged +0.84% on the day, bringing the index within fifty basis points of its March 1 record close of 2,395.96. The first interest rate increase that followed years of rate cuts came in December 2015. Since then, the S&P 500 has climbed +15%. The market curmudgeons warned of a stock market crash once the Fed changed course.

From June 30, 2004 to June 29, 2006, the Fed raised its fed funds target on seventeen consecutive occasions. The rate increased from 1.00% to 5.25%. The S&P 500 rose +12% over the same period. The Fed began cutting rates on September 18, 2007 down to zero by December 16, 2008, during which period the stock market plunged -40%. (Reminder: history teaches us that a market recovery occurs 100% of the time. All market crashes are temporary phenomena.) From 1987 through 1989, the Fed hiked rates 27 times over 28 months, but stocks soared +26% during that time, which included the 1987 crash – case in point. From 1994 to 1995, there was a three-percentage point increase over 12 months. Stocks advanced +20% over the following six months.

Rate increases are not going to derail the market in the short to medium term. Economic data, as well as soft indicators such as confidence indices, all point to a more robust economy. Perhaps we need to hear it from a trucker, at the coal face so to speak. Here is a comment posted online, "You can feel it here in Detroit. I'm a truck driver, run auto parts, hit them all, I am dedicated to none. I hit the plants and the suppliers throughout Michigan, Indiana and Ohio. The air is different in the plants, it actually feels good to be in many of them. Prior to Trump, you could cut the air with a KNIFE. It was anger and hopelessness, that is what I felt, and I am being very serious about that. Now, things have changed, the feeling I get is a 180 from what it was just a matter of a few months ago. The guys on the dock are much more polite. The guys and gals cutting the paperwork are now actually helpful, and POLITE! I have had none of them snap at me…"

The state of the economy will drive the stock market despite the Fed's gratuitous attempts to influence the capital markets. This is not to say that rate increases come without consequences. Those with credit card debt will feel the impact immediately. A quick Google search confirms a troubling statistic. On average, US households carry $16,000 in credit card debt. A 25-basis point increase translates into an additional interest cost of $40 over 12 months. As banks collect more income from borrowers, the frugal among us should begin to see higher rates on our savings, which currently earn us next to zero.

As the economy warms up, the demand for capital will increase. In response, the cost of capital will increase to a point where demand will taper off. The Fed, driven by fears of economic growth stalling will, as in the past, announce a cut in the federal-funds rate, which in itself becomes a self-fulfilling prophecy of economic doom. The "logical" conclusion in the media and among the intellectual elite would be that the Fed, in its infinite wisdom, obviously foresees an impending recession. Hence the need to lower rates in an effort to perk up borrowing demand – a futile exercise that distorts the natural course of economic cycles. When that happens, we can expect a major market correction. No fear, these, on average, do not last more than three to nine months.

As for now, the current bull market, albeit fairly pricey, has room to run. Time to sit down and enjoy a cheese omelet.

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