First Trust
Monday Morning OUTLOOK

630-517-7756 • www.ftportfolios.com August 5, 2019

The Flailing Fed

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The Fed is flailing.

For the past several years, under the leadership of both Jerome Powell and, before that, Janet Yellen, the Fed claimed it was "data dependent." But the decision last week to reduce short-term rates by 25 basis points tore that narrative to shreds.

At the prior Federal Reserve meeting in mid-June, a slender majority of Fed policymakers projected no rate cuts this year. After that, the data flow on the economy was generally better than expected, including solid reports on jobs, retail sales, manufacturing production, and real GDP. These figures undermined the Fed's forecast that real GDP would grow only 2.1% this year. In addition, both consumer and producer prices rose more than expected. If the Fed were really data dependent then, if anything, these data should have moved it away from a rate cut.

The oddest part of the Fed's decision was Powell acknowledging how little its rate cut means. "(W)e don't hear that from businesses. They don't come in and say we're not investing because…the federal funds rate is too high. I haven't heard that from a business. What you hear is that demand is weak for their products." And yet, the US consumer looks pretty strong. Core retail sales, which exclude volatile items like autos, building materials, and gas, are up 4.4% from a year ago and up 10.6% annualized so far this year.

Powell said at the press conference following the meeting that the Fed wants to "ensure against downside risks to the outlook from weak global growth and trade tensions." Yes, Europe and China have experienced slower growth. But some of the slower growth abroad, particularly in China, is a result of changes in trade policy so that the US no longer subsidizes China by turning a blind eye to that country's piracy of intellectual property. And slower growth in Europe is largely a function of structural issues that US monetary policy can't solve: too much redistribution, too much regulation, too much socialism. Moreover, it's not clear that slower growth overseas is a negative for the US; some of the slower growth abroad is because tax cuts and deregulation have made the US a better place to do business.

Another possibility is that the Fed is very concerned about the inverted yield curve, but is too scared to say it. Maybe the Fed thinks very low long-term rates are, in part, a function of weak expectations of future growth (regardless of today's solid growth) and that if short-term rates stay above long-term rates, then eventually businesses and consumers will have an incentive to postpone economic activity because short-term rates will eventually move lower, as well.

But if that's what the Fed thinks then deciding to cut rates only 25 basis points might have been the worst decision it could have made. If the Fed didn't cut rates at all and the Fed's statement and press conference focused on the bright side of the US economy, it could have spurred an increase in long-term interest rates that would help unwind the inversion of the yield curve. Or, as an alternative, the Fed could have cut rates more drastically, in the 50-100 bp range, to make sure short-term rates go below long-term yields, and then make it clear in the statement that the Fed was simply reacting to the yield curve and that the prospects for the economy remain bright. Instead, by reducing rates only 25 bp and letting the markets assume further rate hikes ahead, it did very little to end the inversion.

Our view remains that last week's rate cut wasn't needed, nor are further rate cuts in the months ahead. Nominal GDP is up 4.0% in the past year and up at a 5.0% annual rate in the past two years. Gold is up 12.3% so far this year. There are plenty of excess reserves in the banking system. The Fed is not tight.

At a deeper level, we think the Fed's recent flailing is an inevitable result of the experiment that began during the Panic of 2008 when it started paying banks interest on reserves. The Fed then shifted to implementing monetary policy by *directly* targeting interest rates rather than managing the supply of money and deciding what short-term interest rate was appropriate given its target for the money supply.

Either way, it looks like the flailing Fed is headed for another rate cut at the meeting in September. The Fed is under enormous pressure to reduce rates, both political and from the bond market. Maybe that's why it's having so much trouble articulating a rationale. Eventually, inflation will rise as a result. In the meantime, equities remain very cheap.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-5 / 9:00 am	ISM Non Mfg Index – Jul	55.5	**55.8**	53.7	55.1
8-7 / 2:00 pm	Consumer Credit– May	$16.1 Bil	**$15.4 Bil**		$17.1 Bil
8-8 / 7:30 am	Initial Claims – Aug 3	215K	**213K**		215K
8-9 / 7:30 am	PPI – Jun	+0.2%	**+0.2%**		+0.1%
7:30 am	"Core" PPI – Jun	+0.2%	**+0.1%**		+0.3%

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.