First Trust
Monday Morning OUTLOOK

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Focus on the Money, Not Rates

No one can say that the Federal Reserve can't do the impossible. At long last observers from across the political spectrum agree on one thing – that Jerome Powell and the Fed are well behind the inflation curve and have a lot of catching up to do. These days, that's virtually impossible.

Consumer prices are up 8.5% from a year ago, the largest increase since 1981. And while the Fed is talking tough and lifted the funds rate by a quarter percentage point in March, monetary policy remains very loose.

Chairman Powell has hinted recently at raising the target short-term rate by 50 basis points (a half percentage point) in early May. The market also expects another 50 bp in June and another 100 bp or more, combined, during the four meetings in the second half of the year.

As a result of these projected interest rate hikes, some fear a recession starting as early as this year. And these fears have put pressure on the stock market. The S&P 500 closed on Friday down more than 10% from the all-time high set back in early January.

But we think that for the time being these fears are overblown. Monetary policy is still very loose and would still be loose even if the Fed raised rates to 2.0% or 3.0% immediately.

Before the Financial Crisis in 2008-09, short-term interest rates were a good proxy for judging the stance of monetary policy. The Fed used a system of "reserve scarcity" and lower rates relative to economic fundamentals meant looser policy.

That's because the Fed manipulated the amount of bank reserves in the system to move rates. If it wanted looser money, the Fed would buy bonds from banks, which would increase reserves and lower short-term rates; when the Fed wanted to reduce the growth rate of money, it would adopt a policy to buy fewer bonds (or sell bonds), which meant higher short-term rates. In other words, money supply growth and interest rates were *intertwined*. When one went up the other went down.

But the Fed no longer implements monetary policy that way; the Fed now runs a policy of "plentiful reserves," and the Fed targets the interest rate it pays banks on those reserves. The money supply and the level of rates are now *independent* of each other.

For example, after the Panic of 2008 the Fed reduced the short-term interest rate target to essentially zero and kept it there for seven years. During that time the M2 measure of the money supply grew just 6.0% per year, no different than in the prior seven years. So, even with zero percent interest rates, there was no problem with inflation during those years.

In complete contrast, this time around, with the same zero percent interest rate policy, the M2 measure of the money supply has soared, growing at an 18.7% annual rate in the two years since February 2020 (right before COVID).

This is also why the most important data release this week might not be the GDP report out Thursday but the Fed's release of the M2 money supply report from March, to be released on Tuesday. The Fed used to report these data once per week but switched that to once per month about a year ago. The Fed has the weekly data, but when it decided money didn't matter, it stopped releasing it. This is monetary policy malpractice.

The other thing to keep in mind is that although the recent stock market sell-off has affected the banks, the largest banks will have a big wind at their backs in the next couple of years. As short-term interest rates go up, so too will the amount the Fed pays them in interest on the excess reserves it created in the past fourteen years. Depending on how fast the Fed lifts rates, and whether or not banks choose to hold bonds instead of reserves, the Fed could be paying banks $75 to $100 billion next year.

The bottom line is that monetary policy is still very loose and likely to stay that way. And investors need to follow the money: both M2 overall and the money the banks are getting from the Fed. For now, neither are bearish signs.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-26 / 7:30 am	Durable Goods – Mar	+1.0%	**+1.2%**		-2.1%
7:30 am	Durable Goods (Ex-Trans) – Mar	+0.6%	**+0.6%**		-0.6%
9:00 am	New Home Sales - Mar	0.765 Mil	**0.772 Mil**		0.772 Mil
4-28 / 7:30 am	Initial Claims – April 25	180K	**180K**		184K
7:30 am	Q1 GDP Advance Report	1.1%	**1.5%**		6.9%
7:30 am	Q1 GDP Chain Price Index	7.2%	**6.3%**		7.1%
4-29 / 7:30 am	Personal Income – Mar	+0.4%	**+0.1%**		+0.5%
7:30 am	Personal Spending – Feb	+0.7%	**+0.7%**		+0.2%
8:45 am	Chicago PMI – Apr	62.0	**59.2**		62.9
9:00 am	U. Mich Consumer Sentiment- Apr	65.7	**65.7**		65.7

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.