First Trust
Monday Morning OUTLOOK

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Monetary Mayhem Clouds Crystal Ball

You can't read or watch financial news these days without a heavy dose of speculation about what the Fed is going to do with short-term interest rates, when it's going to do it, and how long it's going to do it for.

There's nothing wrong with paying some attention to this news, but what investors need to realize is that this is not your father's (or mother's) monetary policy and they need to focus on the money supply. (Yes, we know we've written about this before, but this issue is so important it warrants multiple repetitions. Expect another reminder again sometime in the next few months.)

Prior to the Financial Crisis of 2008-09, the Fed implemented monetary policy by either (a) buying Treasury securities from banks to add reserves to the banking system or (b) selling Treasury securities to banks to drain reserves from the banking system. Adding reserves would loosen monetary policy, draining reserves would tighten monetary policy.

Why would the Fed add or drain reserves? Because banks would actively trade reserves among each other on an overnight basis to meet the reserve requirements. The Fed, by adding or draining reserves, could influence the interest rate banks would charge each other to acquire those reserves and that rate was highly sensitive to Fed decisions. This was a "scarce reserve" model for monetary policy. When it was implemented carefully, it delivered persistently low inflation for multiple decades.

Then along came the Financial Crisis and that scarce reserve model was abandoned and replaced with a model based on "abundant reserves." The Fed, through multiple rounds of Quantitative Easing, flooded the banking system with more reserves than the banks would ever need. In turn, the Fed made those reserves valuable by paying the banks an interest rate to hold them. No longer would banks scramble to acquire reserves to meet legal requirements based on the amount of deposits they held; now banks would want them only if and when the Fed paid them enough interest on those reserves, like now, when the Fed is paying banks 4.65% per annum and that figure is likely heading higher during the next few months.

What this means is that short-term rates are ultimately decreed by government edict. The market process (banks trading these reserves) no longer exists. It's our view that investors fixated on these edicts are barking up the wrong tree. What they should be barking at is the money supply.

The M2 measure of the money supply soared in the first two years of COVID, up 40.4% from February 2020 to February 2022. But, in the last ten months of 2022, the M2 measure of money declined 2.3%. Not only have we never experienced a Fed trying to fight an inflation problem under an abundant reserve regime, we've never seen M2 grow so fast for so long, or decline so rapidly, at least since the Great Depression.

At present, the futures market appears to be pricing in three more rate hikes this year, 25 basis points each, with one rate cut of 25 basis points very late this year. There is nothing obviously wrong with this forecast, it sounds reasonable. But this is just a guess about how the Fed's edicts might change. We, on the other hand, will be looking at the January M2 data out next Tuesday, which could tell us if the drop in M2 continued into 2023.

It remains to be seen how shifts in interest rate policy will influence M2 growth in the months ahead. Again, we are in an unprecedented period for policy with abundant reserves, so educated guesses, not definitive answers, are the best anyone can do. One big question is whether the *lifting* of rates has slowed M2 or is it just that rates are *higher*. That may sound redundant, but it's not. Let's say the Fed stops raising rates at a peak of 5.5% and then pauses rate changes. Will that peak level of rates keep putting downward pressure on M2? Or is it the hiking of rates that matters, so M2 will start growing again once the Fed stops raising rates (even though it doesn't cut rates, either)?

This is important because monetary policy hits the economy with long and variable lags. We have already seen some weakness in production reports but are not close to feeling the full brunt of the tighter money that started last year. There is a storm headed our way, so please be prepared.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-21 / 9:00 am	Existing Home Sales – Jan	4.100 Mil	**4.160 Mil**	4.000 Mil	4.020 Mil
2-23 / 7:30 am	Initial Claims – Feb 18	200K	**195K**		194K
7:30 am	Q4 GDP Second Report	2.9%	**2.9%**		2.9%
7:30 am	Q4 GDP Chain Price Index	3.5%	**3.5%**		3.5%
2-24 / 7:30 am	Personal Income – Jan	+1.0%	**+1.3%**		+0.2%
7:30 am	Personal Spending – Jan	+1.4%	**+1.6%**		-0.2%
9:00 am	New Home Sales – Jan	0.620 Mil	**0.619 Mil**		0.616 Mil
9:00 am	U. Mich Consumer Sentiment- Feb	66.4	**66.0**		66.4