First Trust
Monday Morning OUTLOOK
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Fed Talks Louder, To Little Avail

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When someone doesn't speak your language, yet you must communicate, funny things can happen.

At first, most just talk normally, hoping the message somehow gets through with a hand gesture or two. If that doesn't work, some people start…talking...really…slowly, so the other person understands. And if all else fails, how about saying it REALLY LOUDLY, *and emphatically*, to finally get our point across.

That's where the Federal Reserve is today. In its own collective mind, it has a very important message to convey: that monetary policy is going to be as expansionary as necessary to get this economic recovery off the ground.

And yet the economy just doesn't seem to understand. Real GDP grew 2.4% in 2010, 2% in 2011, and then slowed further, to 1.75% in 2012, using the Fed's estimates. In other words, despite the massive expansion of the Fed's balance sheet in the past four years, the economy doesn't understand it is supposed to accelerate.

So what's the Fed to do? Last week the Fed invented another quantitative easing program out of whole cloth. We guess it figures that printing even more money (talking even louder and more emphatically) would help. The Fed has already taken its balance sheet from $900 billion to $2.8 trillion with little impact, so why would a bigger, $4 trillion, balance sheet make the difference?

The problem is that QE has not worked. Banks have responded by increasing their excess reserves – holding assets as deposits at the Fed rather than lending them and allowing the money multiplier to work its magic. In fact, excluding excess reserves, the Fed's balance sheet is smaller than it was in late 2008, in the immediate aftermath of the collapse of Lehman Brothers.

Price-to-earnings ratios are lower today than they were in 2007. So, please don't buy the argument that QE has lifted the stock market. Profits have driven stock prices higher, not QE.

The reason QE hasn't worked is not that the Fed hasn't been clear enough about its intentions, but because tight money is not the reason for tepid economic growth. There is no lack of liquidity in the US economy. It is the huge expansion in government and the failure to address long-term entitlement issues that are the problem. Spending robs the economy of its potential, while the threat of higher future tax rates undermines value.

The one good thing about last week's announcement is that at least the Fed has told us when it will quit. When the unemployment rate gets down to 6.5%, it anticipates starting to raise rates. We forecast this happening around mid-2014, not mid-2015 like the Fed now projects.

Maybe then the Fed will stop yelling and pointing and trying to force something to happen that it can't possibly be responsible for. It's the over-spending and over-regulation that's keeping the recovery so slow, not the amount of money the Fed is creating out of thin air.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-17 / 7:30 am	Empire State Mfg Index – Dec	-1.0	**+1.7**	-8.1	-5.2
12-19 / 7:30 am	Housing Starts – Nov	0.873 Mil	**0.865 Mil**		0.870 Mil
12-20 / 7:30 am	Q3 GDP Final	2.8%	**2.8%**		2.7%
7:30 am	Q3 GDP Chain Price Index	2.7%	**2.7%**		2.7%
7:30 am	Initial Claims – Dec 15	360K	**350K**		343K
9:00 am	Existing Home Sales – Nov	4.900 Mil	**4.880 Mil**		4.790 Mil
9:00 am	Leading Indicators – Nov	-0.2%	**-0.2%**		+0.2%
9:00 am	Philly Fed Survey – Dec	-3.0	**-1.0**		-10.7
12-21 / 7:30 am	Personal Income – Nov	+0.3%	**+0.2%**		0.0%
7:30 am	Personal Spending – Nov	+0.4%	**+0.4%**		-0.2%
8:55 am	U. Mich Consumer Sentiment- Dec	75.0	**75.0**		74.5