First Trust
Monday Morning OUTLOOK

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630-517-7756 • www.ftportfolios.com December 19, 2022

Still Unprecedented

What a difference a year makes!

One year ago the Federal Reserve was forecasting that real GDP would grow a strong 4.0% in 2022, that PCE prices would be up a relatively moderate 2.6%, and we should expect a grand total of three 25 basis point (bp) rate hikes by the end of the year.

Instead, it looks like real GDP will be up about 0.5%, PCE prices will be up 5.6%, and we had the equivalent of seventeen 25 bp Fed rate hikes, finishing the year at 4.375%. So, if you feel a little dizzy about all of this, imagine how the Fed feels.

For 2023, the Fed is forecasting another year of 0.5% real GDP growth, inflation of 3.1%, and the unemployment rate rising to 4.6%. As for Fed policy, the dot plot shows another 75 bps of rate hikes in 2023, and no planned cuts.

We think growth will undershoot the Fed's forecast in 2023. Instead of growing 0.5% in 2023, we expect real GDP will shrink about 0.5%. Meanwhile, we think inflation will overshoot: ending next year above 4.0%. Sure, inflation moderates in 2023, but not as much or as fast as many expect.

What does that mean for the Fed? While others obsess about short-term interest rates, we still think investors (and the Fed) should pay more attention to the money supply, M2 in particular. M2 surged in 2020-21, hitting a peak of 27% year-over-year growth and rising a cumulative 40%. But in the past year, M2 growth hit a wall, and is up just 1% from a year ago. If accurate, this means economic activity is likely to slow very sharply – and soon.

However, we think some of this decline in M2 growth is because the Treasury General Account at the Fed (the Treasury's checking account) grew from $100 billion at the end of 2021, to a current level of $600 billion. In other words, the Treasury has extracted roughly $500 billion of M2 from taxpayers and bond buyers and put it aside in an account that does not count as M2. If we adjust M2 for this sleight-of-hand, M2 is up roughly 4% in the past year, not 1%.

We also can't rule out the possibility that measurement error has led to the Fed miscalculating M2. If M2 has really slowed to 1% in the past year, it's hard to figure out how total bank credit is still up more than 7% from a year ago.

If their calculations are true, the dramatic slowdown in M2 growth in 2022 would be entirely consistent with a recession starting sometime in 2023. But, so far, we don't see evidence of any large squeeze in overall economic liquidity.

Lurking in the background of all these forecasts, including our own, is the fact that we are in unprecedented times. Forget COVID lockdowns; every prior episode of inflation in the post-World War II era was accompanied by the Fed operating in a "scarce reserve" system, whereby it would tighten monetary policy by draining reserves from the banking system to make short-term interest rates move higher. Meanwhile, those reserves would generate zero income for the banks unless they lent them to other banks.

Now, for the very first time with high inflation, the Fed is operating in an "abundant reserve" system, trying to tighten monetary policy by directly paying banks higher interest rates to hold the copious reserves that well exceed banks' needs. The continued growth in bank credit suggests that, so far, this experiment in monetary policy is not quite going according to plan.

Interest rates all along the yield curve remain below every economic model of neutral rates (i.e. The Taylor Rule). The Fed has held the federal funds rate below inflation for 90% of the past thirteen years. This is all part of the unprecedented policies that investors must analyze and deal with.

Put it all together and the only thing we're confident about is that whatever happens in 2023, it will likely look very different from what the Fed is forecasting.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-20 / 7:30 am	Housing Starts – Nov	1.400 Mil	**1.399 Mil**		1.425 Mil
12-21 / 9:00 am	Existing Home Sales – Nov	4.200 Mil	**4.220 Mil**		4.430 Mil
12-22 / 7:30 am	Initial Claims – Dec 18	222K	**219K**		211K
7:30 am	Q3 GDP Final	2.9%	**2.9%**		2.9%
7:30 am	Q3 GDP Chain Price Index	4.3%	**4.3%**		4.3%
12-23 / 7:30 am	Personal Income – Nov	+0.3%	**+0.3%**		+0.7%
7:30 am	Personal Spending – Nov	+0.2%	**+0.2%**		+0.8%
7:30 am	Durable Goods – Nov	-1.0%	**-0.6%**		+1.1%
7:30 am	Durable Goods (Ex-Trans) – Nov	0.0%	**+0.1%**		+0.5%
9:00 am	New Home Sales – Nov	0.600 Mil	**0.599 Mil**		0.632 Mil
9:00 am	U. Mich Consumer Sentiment- Dec	59.1	**58.0**		59.1