First Trust
Monday Morning OUTLOOK

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Senior Economist*
Bryce Gill – *Economist*

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Monetary Muddle

The Federal Reserve raised short-term interest rates by three-quarters of a percentage point (75 basis points) on Wednesday. The day before, the Fed had released M2 money supply data for June and it fell slightly, the second decline in three months. At his press conference after the rate hike, Fed Chairman Jerome Powell was vague about the Fed's future intentions on rates, but was not asked one single question about the money supply.

For now, with the federal funds rate at 2.375%, the futures market is leaning toward a rate hike of 50 bps in September. The Fed has apparently abandoned "forward guidance" partly because it has already pushed rates close to what many Fed members said is "neutral."

Meanwhile, the 10-year Treasury yield has fallen from north of 3.4% to under 2.7% suggesting the market thinks the Fed will either slow down rate hikes, or maybe even cut them next year. Unless, inflation falls precipitously, this makes no sense. "Core" PCE inflation is closing in on 5% and a "neutral" interest rate should be at least that high, or higher. The Fed has never managed policy under its new abundant reserve system with inflation rising this fast. No one, even the Fed, knows exactly how rate hikes will affect the economy under this new system. (See MMO)

Many think the economy is in recession already, because of two consecutive quarters of declining real GDP. But this is a simplified definition. Go to NBER.Org to see the actual definition of recession. A broad array of spending, income, production and jobs data rose in the first six months of 2022. GDP is not a great real-time measure of overall economic activity for many reasons. Jerome Powell does not think the US is in recession, and neither do we. What we do know is that inflation is still extremely high and the only way to get it down and keep it down is by slowing money growth.

And that does look like it's happening. So far this year, M2 is up at only a 1.7% annual rate, after climbing at an 18.4% annual rate in 2020-21. By contrast, M2 grew at a 6.2% annual rate in the ten years leading up to COVID.

Slow growth (or even slight declines) in M2 is good news. The problem is that the Fed never talks about M2 and the press never seems to ask. Moreover, slower growth in M2 may be tied to a surge in tax payments – when a taxpayer writes a check to the government, the bank deposits in M2 fall. Data on deposits at banks back this up. However, banks have trillions in excess reserves and total loans and leases are growing at double digit rates. At this point, it is not clear that the new policy regime can persistently slow M2. Will higher rates stop the growth of loans? This looks to be happening in mortgages, but it appears to be demand-driven, not supply-driven.

The bottom line is that the Fed seems determined to bring inflation down but thinks raising short-term interest rates, all by itself, can do the job effectively, even at the same time that it is willing to hike more gradually when inflation is well above the level of rates. This is not a recipe for confidence in the Fed. Expect rates to peak higher than the market now expects and keep watching M2.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-1 / 9:00 am	ISM Index – Jul	52.0	**52.8**	52.8	53.0
9:00 am	Construction Spending – Jun	+0.1%	**+0.4%**	-1.1%	-0.1%
8-2 / *afternoon*	Total Car/Truck Sales – Jul	13.5 Mil	**13.5 Mil**		13.0 Mil
afternoon	Domestic Car/Truck Sales – Jul	10.7 Mil	**10.6 Mil**		10.3 Mil
8-3 / 9:00 am	ISM Non Mfg Index – Jul	53.5	**54.3**		55.3
9:00 am	Factory Orders – Jun	+1.2%	**+1.1%**		+1.6%
8-4 / 7:30 am	Initial Claims – Jul 31	260K	**253K**		256K
7:30 am	Int'l Trade Balance – Jun	-$80.0	**-$79.4**		-$85.5
8-5 / 7:30 am	Non-Farm Payrolls – Jul	250K	**240K**		372K
7:30 am	Private Payrolls – Jul	228K	**210K**		381K
7:30 am	Manufacturing Payrolls – Jul	20K	**20K**		29K
7:30 am	Unemployment Rate – Jul	3.6%	**3.6%**		**3.6%**
7:30 am	Average Hourly Earnings – Jul	+0.3%	**+0.4%**		+0.3%
7:30 am	Average Weekly Hours – Jul	34.5	**34.5**		34.5
2:00 pm	Consumer Credit– May	$26.0 Bil	**$32.7 Bil**		$22.3 Bil