First Trust
Monday Morning OUTLOOK

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What Should the Fed Do? How About Nothing?

For the first time in roughly fifteen years, interest rates in the United States are about right. In economics, we call it the "neutral" or "natural" rate. The Taylor Rule says rates should be higher, and our model that uses nominal GDP growth (real GDP plus inflation) says the same thing. But both these models rely on data that is still distorted by COVID.

A simpler approach is to assume interest rates should be "Inflation Plus." If we judge current inflation using an average of the Cleveland Median CPI (up 5.3% from a year ago) and overall total CPI (up 3.2% from a year ago) we get 4.2%. "Plus 1%" says rates should be roughly 5.2%. And that's almost exactly where the federal funds rate is today.

This is a big change. Between 2008 and today, the Federal Reserve held the funds rate below inflation roughly 83% of the time. These excessively low rates have created problems.

Banks have hundreds of billions of dollars of mark-to-market losses and government-funded green new deal projects are facing serious problems because they are not profitable at current neutral interest rates. In other words, holding rates down artificially, like the Fed did for years, may make things look OK, but it can't last forever.

At the same time, the Fed grew the M2 measure of money so rapidly in 2020-21 that inflation was easy to see coming. But now the M2 measure of money is contracting. So, with money contracting and interest rates near normal, it seems appropriate to pause. Especially given the fact that tighter money seems to be helping inflation come back down from its post COVID spike.

But it is certainly not time to claim victory and return to an environment of artificially low rates. That would risk repeating the 1970s, when Arthur Burns cut rates before eradicating inflation. If, as we suspect, the US economy enters recession in 2024, the political pressure on the Fed to cut rates and restart QE will be intense. But it would be a big mistake unless inflation continues to fall and thereby reduce the "neutral" interest rate. All it would do is continue the mistakes of the past fifteen years.

One interesting thing we have observed is how much bank regulators, Fed members, and Treasury officials have shifted their thinking. Back in 2008, Hank Paulson, Ben Bernanke and Sheila Bair religiously adhered to mark-to-market (MTM) accounting. We still blame this accounting convention for the financial panic that ensued. But that panic was used to justify growing the Fed's balance sheet by trillions of dollars with QE and supporting TARP, which grew the size of the federal government.

These policies were supposed to make the US financial system safer, but they didn't. Because the Fed became so powerful and flooded the banking system with deposits (at artificially low rates), bank balance sheets now have an estimated $675 billion in losses on them.

Interestingly (and thankfully) banks don't have to mark these assets to market anymore. It would wipe out almost a third of bank capital. But what happened to all these MTM believers? Did they only believe in MTM accounting when they could blame it on banks? Now that it is clear the Fed's policies caused the losses, are they trying to avoid blame?

The bottom line is that those who think the Fed can just manage its way out this easily, cutting rates to offset the pain of recession (or avoid one entirely), may not be correct. Many seem to have submitted to "state-run capitalism." But history shows it has never really worked. The Fed is likely to "do nothing" this week and holding that position in 2024 might not be a bad thing.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-12 / 7:30 am	CPI – Nov	0.0%	**0.0%**		0.0%
7:30 am	"Core" CPI – Nov	+0.3%	**+0.3%**		+0.2%
12-13 / 7:30 am	PPI – Nov	+0.1%	**0.0%**		-0.5%
7:30 am	"Core" PPI – Nov	+0.2%	**+0.2%**		0.0%
12-14 / 7:30 am	Initial Claims – Dec 9	220K	**221K**		220K
7:30 am	Retail Sales – Nov	-0.1%	**-0.1%**		-0.1%
7:30 am	Retail Sales Ex-Auto – Nov	-0.1%	**-0.1%**		+0.1%
7:30 am	Import Prices – Nov	-0.8%	**-0.7%**		-0.8%
7:30 am	Export Prices – Nov	-1.0%	**-0.2%**		-1.1%
9:00 am	Business Inventories – Oct	-0.1%	**-0.1%**		+0.4%
12-15 / 7:30 am	Empire State Mfg Index – Dec	2.1	**-0.8**		9.1
8:15 am	Industrial Production – Nov	+0.3%	**+0.4%**		-0.6%
8:15 am	Capacity Utilization – Nov	79.1%	**79.1%**		78.9%