First Trust
ECONOMIC RESEARCH REPORT
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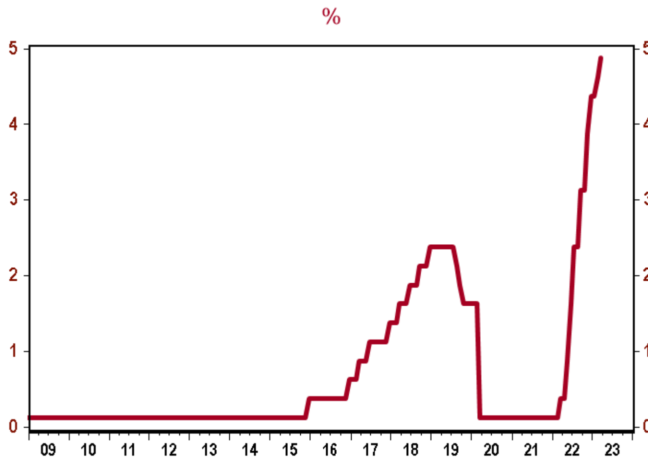
March 22, 2023 • 630.517.7756 • www.ftportfolios.com

All Mixed Up

The Fed raised short-term rates by another 25 basis points (bp) today and made no changes to the expected peak for short-term rates later this year. That peak is still 5.125% – 25 bp higher than they are today – just like the forecast back in December.

However, there were other significant changes, both explicit and otherwise, to the Federal Reserve's statement and outlook on monetary policy, as well as the economy. In particular, the economic forecast from the Fed shows real GDP growing 0.4% this year. What's odd about that forecast is that the Atlanta Fed's GDP Now model currently projects growth at a 3.2% annual rate in the first quarter while we are estimating growth at a roughly 2.0% rate. Even if you take our slower growth rate for Q1, the only way you'd get to a 0.4% growth rate for 2023 as a whole would be for real GDP to be lower in the fourth quarter than it is likely to be in Q1.



In other words, the Fed is likely now forecasting a recession starting later this year even as it continues to say it will not cut rates later this year. Meanwhile, the Fed ticked up the median dot for the end of 2024, suggesting short-term rates will end next year at 4.3% versus a December forecast of 4.1%. Put it all together and we have a Fed prepared to not reduce rates as rapidly during the next recession as it did in 2020 or 2008-09.

Although the Fed noted recent problems in the banking system and that these problems might impact the economy and inflation, the Fed went out of its way to end that portion of the statement with language that it "remains highly attentive to inflation risks." Notice the emphasis on inflation risks, not downside risk to the economy, which seems like is already built into its forecast.

However, the Fed also opened the door to dovishness if banking problems intensify. Previously, the Fed had said that "ongoing increases in the target range will be appropriate…" That was replaced by "some additional policy firming may be appropriate..." Notice the "ongoing" replaced by "some additional" and "will" replaced by "may." We interpret that to mean the Fed will be in no rush to raise rates at the next meeting and will instead sit back and watch how events in the economy and banking system unfold before May 3.

Ultimately, we believe investors need to focus on the M2 measure of the money supply, not the target level of short-term rates. It is M2 that will tell us what the net effects of all the Fed's policies and the banking situation are. The Fed and other policy authorities in Washington, DC have, at least temporarily, ring-fenced traditional banks, guaranteeing all deposits in FDIC-insured accounts, no matter how high. This will prevent a bank run, kicking the can down the road for future policymakers to deal with the problem.

Meanwhile, a new bank term funding program will allow banks access to potentially huge injections of capital from the Fed while the banks pay very small fees to the Fed for the service. And yet, while expanding its balance sheet this way, the Fed will simultaneously continue its passive version of Quantitative Tightening, letting a portion of its balance sheet decline as some securities mature. This is like a car with two steering wheels with the driver turning them in opposite directions at the same time.

The Fed is all mixed up. The reason it's mixed up is because in the 2008-09 crisis it abandoned its long tradition of implementing monetary policy through scarce reserves and imposed a new policy based on abundant reserves. They didn't know where it was heading at the time; now we're finding out. The turmoil in the markets isn't over. We remain cautious on equities and think a recession is on the way.

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Text of the Federal Reserve's Statement:

Recent indicators point to modest growth in spending and production. Job gains have picked up in recent months and are running at a robust pace; the unemployment rate has remained low. Inflation remains elevated.

The U.S. banking system is sound and resilient. Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. The extent of these effects is

uncertain. The Committee remains highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 4-3/4 to 5 percent. The Committee will closely monitor incoming information and assess the implications for monetary policy. The Committee anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the extent of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. The Committee is strongly committed to returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; Lisa D. Cook; Austan D. Goolsbee; Patrick Harker; Philip N. Jefferson; Neel Kashkari; Lorie K. Logan; and Christopher J. Waller.

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