

The Fed Waffles

The Federal Reserve raised short-term interest rates by another quarter point on Wednesday. That, by itself, was clear, with the Fed now targeting a range for short-term rates between 4.75% and 5.00%. The problem was that the Fed continues to ignore the most important issue in monetary policy.

That most important issue is the money supply, which surged by 40% in the first two years of COVID, the fastest since the 1940s, and has since dropped by the most since the Great Depression. You would think a central bank would pay attention to the amount of money its policy measures create, but apparently that's still not a priority for the Fed or the Washington, DC Press Pundits that cover the Fed.

Neither the Fed's statement on monetary policy nor Fed Chairman Jerome Powell's post-meeting press conference mentioned the money supply. Nor did anyone in the press ask him one question about it. Which is weird because it's the most obvious explanation for what happened with inflation the last few years.

If low short-term interest rates, all by themselves, caused high inflation we would have had very high inflation in the aftermath of the Great Recession and Financial Panic of 2008-09, back when short-term rates were kept lower for even longer than during COVID. If "supply-chain disruptions" were the key reason for high inflation then why has inflation remained so high even as the number of ships waiting at ports is back to normal and inventories have recovered?

By contrast, if you follow the M2 measure of money you would have seen the inflation surge coming.

Instead, the Fed continues to dwell on its target for short-term rates and where it might be headed in the next few years. The new "dot plot" from the Fed suggests one more quarter-point rate hike this year, although seven of eighteen policymakers thought rates would peak even higher.

Keep in mind that between now and the next meeting in early May the Fed will not see much key new information on the path of the economy. We think the Fed pays the most attention to the employment report and the CPI report and we only get one

of each between now and that meeting. Yes, we get a GDP report for Q1 but that's based on data that's mostly behind us.

Meanwhile, it looks like the federal government has "ring-fenced" the financial system against a run on the banks anytime in the near future. Treasury Secretary Yellen may suggest otherwise, but we think it's highly unlikely they'd let a bank fail if they think it would generate a massive flight of deposits to the largest banks or into money market funds. Instead, policymakers are content to let problem banks keep operating, like they did in Japan in the 1990s.

In addition, it's important to recognize that current financial problems are very different from those of 2008-09. Back then, the main issue was credit risk (primarily regarding residential real estate loans and securities) and how markets were pricing that risk. Today the primary issue is interest-rate risk (or duration risk) on high-quality bonds. But the Fed has set up a new facility for banks that lets them, in effect, offload those securities to the Fed for a small fee, papering over balance sheet problems for banks able to take a small hit to earnings.

The oddest part of the Fed's actions on Wednesday was issuing an economic forecast that included a recession starting later this year but not talking about it. That's right, the Fed is now forecasting a recession that starts later this year.

How do we know this? Because the Fed is forecasting 0.4% growth in 2023 even as the Atlanta Fed's GDP Now model projects a 3.2% real GDP growth rate in Q1. Even if you plug in 2.0% for Q1, the only way to get 0.4% for 2023 with 2.0% in Q1 is if the level of real GDP is lower in the fourth quarter than it is in the first quarter. Factor in the Fed forecast that unemployment averages 4.5% in Q4 (versus 3.6% in February) and it looks like a recession forecast.

The Fed could do a better job by refocusing on M2 and being clear about its forecast. But don't get your hopes up. The bottom line is that we think the Fed is right about a recession, which means earnings will take a hit and investors should remain wary.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-30 / 7:30 am	Initial Claims – Mar 25	195K	195K		191K
7:30 am	Q4 GDP Final Report	2.7%	2.7%		2.7%
7:30 am	Q4 GDP Chain Price Index	3.9%	3.9%		3.9%
3-31 / 7:30 am	Personal Income – Feb	+0.2%	+0.2%		+0.6%
7:30 am	Personal Spending – Feb	+0.3%	+0.2%		+1.8%
8:45 am	Chicago PMI – Mar	43.0	43.9		43.6
9:00 am	U. Mich Consumer Sentiment- Mar	63.2	62.0		63.4