First Trust Weekly OUTLOOK

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The Lags are Over for Tighter Money

As Milton Friedman taught us many decades ago, monetary policy works with long and variable lags. Recent economic reports suggest that the long and variable lags on the tightening of monetary policy in 2022-23 are starting to come to an end.

Both inflation and economic growth are decelerating. Consumer prices declined 0.1% in June, the largest drop for any month since the early days of COVID. Much of this was due to a decline in energy prices, but even "core" consumer prices were soft, up only 0.1% for the month, the smallest increase for any month in more than three years. The CPI was still up 3.0% in June versus the year prior, but this year-ago comparison looks like it decelerated in July and will probably do so again in August, given that oil prices are down.

Meanwhile, we are seeing more and more softness in the economy. The housing sector remains mired in slow construction and slow sales. The dollar value of new private housing construction is down in each of the past three months. Recent existing home sales are near the lowest level since the housing bust in 2010; new home sales are lower than they were prior to COVID.

The national ISM Manufacturing index came in at 46.8 for July, below the forecast from every economics group that submits a forecast to Bloomberg and, more important, below 50, which signals contraction. The production component of the index declined to 45.9, the lowest since the COVID Lockdown.

And then the July employment report showed a marked deceleration in job creation, with payroll gains (net of downward revisions for prior months) a tepid 85,000. We like to follow payrolls excluding government (because it's not the private sector), education & health services (dominated by government) and leisure & hospitality (which is still recovering from COVID Lockdowns). That "core" measure of payrolls rose just 17,000 in July, the smallest gain so far this year. At the same time, the unemployment rate rose to 4.3%, 0.4 percentage points higher than it was three months ago, an increase that in the past has often (but not always) been associated with a recession.

It is true that the M2 measure of money bottomed in October and has since been trending upward, but the gain since then has only been 2.4% annualized, much slower than the 6.1% annualized average during the twenty years leading up to COVID, a time when the CPI gained a moderate 2.1% per year.

Put it all together – decelerating inflation and decelerating growth, along with an abnormally slow rebound in M2 – and we have a strong case that the Federal Reserve has implemented tight money. In turn, given the lags between shifts in policy and its economic effects, the Fed now has room to shift to a monetary policy that is less tight.

To most analysts and investors, that means cutting the short-term target rate. As of late Sunday, the futures market in federal funds showed almost 125 basis points in rate cuts later this year. But lower rates, by themselves, are not easier monetary policy.

Instead, the Fed needs to start focusing on the money supply, particularly on M2. If the Fed cuts short-term rates but growth in the money supply remains weak because of tighter capital requirements on banks or because businesses and consumers expect even lower rates further ahead (which might lead them to temporary postpone economic activity) then it isn't really making monetary policy less tight.

There is a widespread myth that 1980s Fed Chairman Paul Volcker beat inflation by sharply raising short-term interest rates. In truth, he did no such thing. What Volcker did was focus on the money supply and getting its growth under control. That meant using the Fed's open-market operations to soak up excess liquidity. And it was those operations which *resulted* in higher short-term rates *and* lower inflation. The causation is important: less money meant higher rates, but Volcker's focus was on the money. If he could have withdrawn the excess liquidity without higher rates, he would have been happy to do so.

The problem today is that the current Fed has abandoned a focus on the money supply and has swapped a system of scarce reserves for one in which reserves are excessively abundant, which means short-term interest rates are directly controlled by the government, rather than the market.

Investors have a great deal riding on whether the Fed gets it right. Focusing on the money supply will help show how successful the Fed will be.

And, finally, there is a real potential here for the Fed to overreact. The world has gotten used to extremely low interest rates and very easy money. The stock market was overvalued and unemployment was artificially low. If the Fed thinks that was normal it will try to add more money than needed and risks creating stagflation. Just like it did in the 1970s.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-5 / 9:00 am	ISM Non Mfg Index – Jul	51.0	**51.0**	51.4	48.8
8-6 / 7:30 am	Int'l Trade Balance – Jun	-$72.5 Bil	**-$71.2 Bil**		-$75.1 Bil
8-7 / 2:00 pm	Consumer Credit – Jun	$10.0 Bil	**$7.6 Bil**		$11.4 Bil
8-8 / 7:30 am	Initial Claims – Aug 3	243K	**244K**		249K

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