First Trust Weekly OUTLOOK

Brian S. Wesbury – Chief Economist
Robert Stein, CFA – Dep. Chief Economist
Strider Elass – Senior Economist
Andrew Opdyke, CFA – Economist
Bryce Gill – Economist
Nate Gerze – Economic Analyst

www.ftportfolios.jp • 26 August 2024

Rate Cuts on the Way

We all knew it was coming…and in Jackson Hole, Federal Reserve Chairman Jerome Powell said it will come next month. He said, "the time has come," and the futures markets have priced in either a 25 or 50 basis point rate cut at the meeting on September 18.

While the world seems to think the setting of the federal funds rate is the most important decision in monetary policy, we don't think that's true. With the advent of the abundant reserve policy in 2008, the Fed separated the link between the money supply and interest rates.

In reality there are multiple things we watch to determine the stance of monetary policy. Interest rates are one, but the rate of growth in M2 is more important…and that growth rate can now be influenced by what the Treasury Department does with the $730 billion it holds at the Fed in something called the Treasury General Account (TGA).

We think the real reason inflation has slowed is because the Fed actually allowed M2 to decline after the massive increase during COVID. Yes, short term interest rates were very low. But it wasn't those low rates that caused the inflation, otherwise short-term rates that were just as low in the aftermath of the 2008-09 Financial Crisis would have caused a similar surge in inflation.

Similarly, it wasn't the hikes in short-term interest rates that brought inflation back down. It was the slowdown in M2, in part caused by the growth of the TGA, which the government has used to take roughly $700 billion out of circulation.

This new system of abundant reserves and a large TGA has pushed the US very close to Modern Monetary Theory, where the Treasury can take money out of circulation by borrowing or taxing from the public and then hiding it in the TGA. And the Treasury could always drain the TGA and push $700 billion back into circulation by spending.

We don't know exactly what the Treasury or Fed will do with Quantitative Easing/Tightening and the TGA, but many seem to believe cutting rates will allow the US to avoid a hard landing. With M2 barely growing, this may not work.

Since 2008, the Fed has held short-term interest rates below inflation 80% of the time, and for nine years, interest rates were basically held at zero. With inflation running 2.5% to 3.0%, the Fed could take the federal funds rate down a full percentage point to roughly 4.5% and rates would be "normal," unless and until inflation falls further.

Meanwhile, the housing market is probably not poised to surge as short-term interest rates start to decline. Mortgage rates are not going to fall back to 3%. In addition, when the Fed starts cutting rates and people think they will cut them more, they could hold back on purchases waiting for the even lower rates. So sometimes, rate cuts can lead to slower growth in the near term. Also, we have a presidential candidate suggesting a large tax credit for some buyers, which could also postpone purchases into next year.

The Fed has been running an experiment in new monetary policy…in other words, don't start believing that this change in direction from higher for longer, to lower is the way to stick the landing. We still haven't felt the full pain from policies undertaken during COVID lockdowns…it takes a lot of imagination to believe all this can happen with no real negative impact.

We are worried that we have come very close to state-run capitalism. In the past year, 82% of all net new jobs have been in government, healthcare and education. Growing budget deficits have been holding up the economy even though the money supply has gone negative. Now, with deficits no longer rising as rapidly, the Fed will try to become the engine behind growth.

But pushing growth with government spending and Fed policy is a dangerous mix that could ignite the embers of inflation before the fire is completely put out. Gold rose to a record high last week, Bitcoin rallied too. The markets are not convinced that inflation has been tamed.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-26 / 7:30 am	Durable Goods – Jul	+5.0%	**+5.8%**	+9.9%	-6.7%
7:30 am	Durable Goods (Ex-Trans) – Jul	-0.1%	**-0.2%**	-0.2%	+0.4%
8-29 / 7:30 am	Initial Claims – Aug 24	233K	**234K**		232K
7:30 am	Q2 GDP Preliminary Report	+2.8%	**+2.8%**		+2.8%
7:30 am	Q2 GDP Chain Price Index	+2.2%	**+2.3%**		+2.3%
8-30 / 7:30 am	Personal Income – Jul	+0.2%	**+0.2%**		+0.2%
7:30 am	Personal Spending – Jul	+0.5%	**+0.4%**		+0.3%
8:45 am	Chicago PMI – Aug	44.5	**45.6**		45.3