

Making the Fed Great Again

To say the least, since its inception in 1913, the Federal Reserve has had its ups and downs. One thing most people don't know is that prior to the invention of the Fed, other than during wars, there was almost no inflation. Various sources including the Federal Reserve regional banks show the purchasing power of \$1 in 1900 was the same as or higher than it was in 1800.

The Government did print and borrow money during wartime, which caused inflation during the War of 1812 and the Civil War. In between wars, when the US was often on a gold standard, the economy experienced deflation.

A gold standard basically keeps the money supply stable, but technology increases the production of goods and services, so if we don't print more money, the average dollar price of things falls. More goods chasing the same amount of dollars creates deflation (actually "good" deflation).

Since 1913 (and the invention of the Fed), the US has experienced cumulative inflation of 3,297%. A massive difference when compared to the 1800s. Moreover, as Milton Friedman proved, it was Fed mistakes with monetary policy that caused the Great Depression. Then, in the 1960s and 1970s, because the Fed printed too much money the US experienced double digit inflation.

Paul Volcker took over the Fed in 1979 and fixed the Fed's inflation problem but ended up causing two sharp recessions during that process. Alan Greenspan followed Volcker and, from 1985 to 1998, the Fed ran spectacularly good monetary policy. Then it tightened too much in 1999 and then loosened too much during the dot.com crash. Excessively low rates from 2000-2005 caused a housing bubble which eventually became the Great Financial Crisis.

In our opinion, the Fed's reaction to that crisis (printing trillions of dollars with Quantitative Easing) was a huge mistake. The Fed followed it up with even more QE during COVID, and that easy money caused the worst inflation since the 1970s.

Like we said, the Fed has had its ups and downs. One thing we don't think enough people think, or talk, about is how much QE has changed our banking system and monetary policy. We've written about it frequently.

To summarize it in a nutshell: It is a myth that QE saved the economy in 2008. We started QE in September and passed TARP in October 2008. The S&P 500 fell an additional 40% in the next six months. When we ended overly strict mark-to-market accounting in March 2009, the economy and market both bottomed.

What QE did was flood the banks with reserves as the Federal Reserve grew its balance sheet massively. So, instead of selling bonds into a free market, the Treasury sold them at interest rates well below inflation because the Fed was buying them. This money ended up as deposits in banks.

In order to keep that money contained, the Fed increased capital requirements and liquidity rules on banks to absurd levels. The Fed also paid banks to hold those reserves. In other words, the Fed took the risk of owning Treasury debt and mortgage-backed securities while banks held risk free reserves.

During QE 1,2&3 those reserves stayed contained and did not cause inflation. But when Jerome Powell did QE during COVID, he reduced liquidity rules and M2 grew 42%...it was the easiest forecast of inflation we have ever made. The crazy thing is that Powell won't talk about M2...reporters won't ask about it at his press conferences because he just denies that there is any relationship. He still blames supply chains for inflation.

More importantly, the Fed's QE has created income inequality and a divide between the young and the old. Because capitalism is often blamed for inequality, it's no wonder almost 2/3rds of Americans under 30 have a "favorable view" of socialism.

So when J. Powell complains about threats to Fed Independence, can he actually understand that Fed policy has influenced politics more than any other time in history? Tripling the money supply in 18 years is massive interference in economic activity and it impacts the political world.

We want an Independent Fed, but what the Fed has done has complicated that. And now with Powell not leaving the Fed, he is doubling down on his mistakes. He should go. Let Kevin Warsh take over. And move to unwind QE.

Fed policy in the next few months will be interesting. The market is actually pricing in a rate hike, mainly because the CPI and PPI both exceeded consensus last month. However, the money supply is still growing relatively slowly and housing prices are growing only 1% YOY. In other words current inflation is likely influenced by Iran, not the money supply. We still think it is more contained than the market thinks.

Kevin Warsh apparently wants to do QT and cut interest rates at the same time. We are not sure this is a wise policy to follow, however, at least it is a change from what we have been doing lately. It's time to make the Fed great again...that means following a different path. And we certainly hope Kevin Warsh is the chair to do that. Powell certainly wasn't.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-21 / 7:30 am	Initial Claims – May 16	210K	207K		211K
7:30 am	Housing Starts – Apr	1.415 Mil	1.415 Mil		1.502 Mil
7:30 am	Philly Fed Survey – May	18.0	10.9		26.7

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