

## Soft Landing

We wrote last week about the soft landing that markets now seem to expect. If the US does have a soft landing it would be because the Federal Reserve tightened enough to slow inflation, but not enough to throw the economy into recession.

In our opinion, Fed policy should not be measured using interest rates alone. The Fed held the federal funds rate at 0% from 2008 to 2015 without inflation. During COVID, the Fed held the funds rate at zero for just two years. If seven years didn't cause inflation, how did two years?

The answer to that question is that following the financial crisis, the Fed shifted to an "abundant reserve" monetary policy and held rates at zero, but increased capital requirements and liquidity rules by enough to keep the M2 money supply in check.

During COVID, the Fed expanded reserves through Quantitative Easing again but relaxed liquidity rules; using banks to distribute pandemic loans and hand out unemployment checks. As a result, M2 peaked at 27% year-over-year growth in February 2021. This is why inflation accelerated, right on time to prove Milton Friedman correct again.

Looking at the two things the Fed can control – interest rates and the growth rate of the money supply – there is a massive divergence. The funds rate is still below inflation. Looking at just rates, monetary policy is not yet tight.

But, looking at M2, money is tight. The growth rate of M2 has slowed from 27% year-to-year in early 2021, to 12% in January 2022, to 0% in November 2022. Given that Milton Friedman told us a slowdown in M2 growth would impact economic growth with a lag of roughly six to nine months, the economy should be showing the impact. There are a few signs of slow growth (like the ISM surveys showing contraction), but gold prices are surging (up \$260 per ounce in the past three months) and the jobs market hasn't weakened materially.

Hold on, though, before thinking that M2 doesn't matter, it is important to remember that pandemic policies were unprecedented. Shutting down most services, and only really opening them up freely in 2022, has distorted economic data. Services were held below trend for two years and are now artificially boosted – no matter what money growth does.

In addition, when the Fed started its Abundant Reserve monetary policy, the Treasury started using its Fed checking account, called the Treasury General Account (TGA) to hoard money. For decades, the TGA had an average balance of roughly \$5 billion. But, lately, the TGA has held hundreds of billions and this money does not count as M2 even if it is cash held at the Fed.

Taxpayers write checks from their bank accounts. If the Treasury puts those taxes in the TGA rather than spending them, they do not return to the banking system. From the end of 2021 to November 2022, the TGA grew from \$134 billion to \$524 billion. In other words, M2 was reduced by \$390 billion because the Treasury held cash out of the system. This has slowed reported M2 growth and just maybe money isn't as tight as it appears.

Another sign that money may not be as tight as it appears is that loans and leases at banks are up 12% in the year ending December even though M2 has not grown.

Nonetheless, money growth has slowed rapidly. When the money supply brakes are slammed, economic growth should suffer before inflation comes down. When this happens at the same time that distortions caused by pandemic policies come to an end, a recession seems inevitable.

Our forecast for real GDP growth this year is -0.5%, with inflation remaining above 4%. In other words, a recession with higher inflation – stagflation. That's what we expect...and it's not a soft landing.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
1-17 / 7:30 am	Empire State Mfg Survey – Jan	-8.7	<b>-8.7</b>	<b>-32.9</b>	-11.2
1-18 / 7:30 am	Retail Sales – Dec	-0.9%	<b>-1.0%</b>		-0.6%
7:30 am	Retail Sales Ex-Auto – Dec	-0.5%	<b>-0.5%</b>		-0.2%
7:30 am	PPI – Dec	-0.1%	<b>0.0%</b>		+0.3%
7:30 am	“Core” PPI – Dec	+0.1%	<b>0.0%</b>		+0.4%
8:15 am	Industrial Production – Dec	-0.1%	<b>-0.1%</b>		-0.2%
8:15 am	Capacity Utilization – Dec	79.5%	<b>79.5%</b>		79.7%
9:00 am	Business Inventories – Nov	+0.4%	<b>+0.4%</b>		+0.3%
1-19 / 7:30 am	Initial Claims – Jan 14	212K	<b>210K</b>		205K
7:30 am	Housing Starts – Dec	1.355 Mil	<b>1.351 Mil</b>		1.427 Mil
7:30 am	Philly Fed Survey – Jan	-11.0	<b>-11.7</b>		-13.8
1-20 / 9:00 am	Existing Home Sales – Dec	3.950 Mil	<b>3.990 Mil</b>		4.090 Mil

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security. Such statements are generally identifiable by the terminology used, such as “plan”, “anticipate”, “intend”, “expect”, “estimate”, or other similar wording. These forward-looking statements are subject to known and unknown risks and uncertainties and other factors that are beyond the control of the Funds, FT Portfolios Canada Co. and its affiliates, and First Trust Advisors L.P. and which may cause actual results, levels of activity and achievements to differ materially from those expressed or implied by such statements. Such factors include, but are not limited to: general economic, market and business conditions; fluctuations in securities prices, fluctuation in interest rates and foreign currency exchange rates; and actions by governmental authorities. Future events and their effects on a fund may not be those anticipated by us. Actual results may differ materially from the results anticipated in these forward-looking statements. We do not undertake, and specifically disclaim, any obligation to update or revise any forward-looking information, whether as a result of new information, future developments or otherwise. This information does not constitute a solicitation or an offer to buy or sell any security.