First Trust Portfolios Canada
Monday Morning OUTLOOK

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The Monetary Muddle

The Federal Reserve meets in three weeks, and right now, futures markets are pricing in a rate hike of at least a quarter percentage point and maybe one-half. Why? Because inflation continues to fly above the Fed's target rate of 2% and at the same time, the job market has been stronger than expected.

The Fed tilts heavily in a Phillips Curve - Keynesian direction and believes stronger growth (and more jobs) causes higher inflation. So do a vast majority of analysts and investors. We are saddened by this: Reagan, Kemp, Friedman, Volcker, Laffer, and Kudlow taught us in the 1980s that stronger growth actually leads to lower inflation.

Compare GDP growth and inflation in the 1980s versus the 1970s. The evidence is clear…we slowed money growth and raised interest rates in the early 1980s, but cut marginal tax rates. Viola! More goods chased fewer dollars, and so inflation was reduced in a life altering way.

But virtually nobody believes this. For some reason economics has become so dumbed down that people actually think economies can be controlled by central banks lifting or cutting rates by 25 basis points at a time.

This is, was, and always has been untrue. Yes, Volcker's policies lifted interest rates. But that was the "impact" of his policies, not the "goal." His goal was to slow money growth to stop inflation.

But, back then, interest rates and the money supply were connected. If the Fed pushed more money into the economy then interest rates fell. What Volcker did was squeeze the amount of money the Fed was adding to the economy…The result: interest rates jumped…sharply. But it was the tighter money growth that caused inflation to fall, not higher interest rates. As we said before; more goods chasing less money.

None of this can happen anymore. Why? Because since Ben Bernanke started Quantitative Easing, the link between the money supply and interest rates has been severed. If the Fed raises rates, the desired effect is to make banks hold reserves more dearly, reducing lending, reducing demand, and taming inflation. But, if at the same time it is raising rates it lets the money supply grow faster, none of that will happen and inflation would get worse.

Even if the Fed did not increase the money supply, but by hiking rates caused slower growth, inflation could become worse. Imagine an economy where there are $10 dollars and 10 apples…each apple is worth $1 dollar. But raising interest rates causes one apple grove to go out of business and now there are only 5 apples…so each apple costs $2 dollars. Raising interest rates certainly has hurt housing affordability and held back supply.

This is what bothers us so much about the Fed, and serious analysts and academics, letting everyone believe all the Fed has to do is lift interest rates a little bit and inflation will be solved. Nothing could be further from the truth. If this were true then low rates would have caused inflation. They did when Jay Powell held them at 0% for two years, but not when Ben Bernanke held them at 0% for seven(!) years. If rates were so powerful, why the difference?

The answer is that money growth stayed calm under Bernanke but soared when Powell monetized government debt. We believe the Fed should look directly at the impact of delinking interest rates and the money supply and it is possible that Warsh's new task forces will do just that. He has already said the Fed's choices caused the inflation surge during COVID.

Former Fed Chair Powell will, of course, defend his actions and the status quo. Hopefully the outcome of the recent election will be enough for Powell to leave by early next year. This would allow a new Fed to seriously study its past actions.

By flooding the system with reserves the Fed has basically become a "price fixer" – it literally sets short-term rates wherever it likes. We expect a rate hike in three weeks and think a 50 bps move is now seriously on the table. The market agrees.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-16 / 7:30 am	Empire State Mfg Survey – Nov	18.0	**15.8**	7.8	25.5
11-17 / 7:30 am	Retail Sales – Oct	+0.2%	**+0.1%**		+0.8%
7:30 am	Retail Sales Ex-Auto – Oct	+0.4%	**+0.3%**		+0.9%
7:30 am	Import Prices – Oct	+0.7%	**+0.4%**		+1.1%
7:30 am	Export Prices – Oct	+0.4%	**+0.3%**		+2.2%
8:15 am	Industrial Production – Oct	+0.1%	**-0.1%**		+0.7%
8:15 am	Capacity Utilization – Oct	76.8%	**76.8%**		76.9%
9:00 am	Business Inventories – Sep	+0.5%	**+0.5%**		+0.4%
11-18 / 7:30 am	Housing Starts – Oct	1.250 Mil	**1.251 Mil**		1.221 Mil
11-19 / 7:30 am	Initial Claims – Nov 14	198K	**198K**		200K
7:30 am	Philly Fed Survey – Nov	21.0	**26.2**		20.9

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