First Trust Portfolios Canada
Monday Morning OUTLOOK

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Monetary Musings

The stock market surged to new highs after the Federal Reserve cut the federal funds rate last week and the futures market has priced in more cuts to come. However, these cuts have not helped reduce long-term interest rates and the price of gold has surged to over $3,700 an ounce.

Clearly, many investors are concerned rate cuts are unwarranted. After all, the Consumer Price Index up 2.9% in the past twelve months, which is higher than it was a year ago. We won't get August PCE inflation – the Fed's preferred measure – until Friday, but it looks like these prices are up 2.8% versus a year ago compared to 2.3% in the year ending in August 2024.

Either way, it looks like we are further from the Fed's 2.0% target for inflation than we were a year ago, so isn't cutting rates playing with the inflation fire?

We think inflation is always and everywhere a monetary phenomenon, just like Milton Friedman explained many decades ago. Some economists, including those at the Fed, think the money supply is no longer useful. But, without the money supply, they still don't have a good explanation for why inflation surged to 9.1% by 2022, the highest since the early 1980s.

After all, the Fed held short-term interest rates near zero for seven years (2008 – 2015) in the aftermath of the Great Recession and inflation remained under control. During COVID, it only held rates at zero for two years. If seven years of zero didn't cause inflation, how did two? The only solid explanation is the money supply, which remained contained after 2008 because of more stringent capital and liquidity rules on banks. During COVID the Fed loosened those rules, facilitating an unprecedented 40% surge in the M2 measure of money over a two-year period. That's why we had an inflation surge.

Yes, we understand COVID lockdowns and deficit spending were highly unusual. We also understand that the lags between shifts in the money supply and subsequent inflation can be long and variable. But it's hard to see how the M2 surge from 2020-22 would still be having a major effect today.

Inflation is much lower than its peak and that aligns with much slower money growth in recent years. M2 contracted (which is highly unusual) in 2022-23 and since then is up at an average annualized rate of only 3.9% and up only 1.7% versus the 2023 peak. For comparison, M2 grew about 6% per year in the decade prior to COVID with much lower inflation.

Yes, tariffs raise the prices of some items, but if the money supply doesn't change, prices for other things must fall. For example, home prices have flattened in recent months and rents for new tenants declined 8.4% in the second quarter this year, the steepest drop on record for any quarter going back to 2005. In time, this will have an impact on the government's measure of rent, which will help put downward pressure on inflation measures, as well. In other words, the Fed may be cutting rates, but it's the money supply that matters.

More importantly, after years of holding rates below inflation, interest rates are now above inflation. In other words, the Fed is not unwarranted in cutting rates. The rate cuts priced into the market still leave the "real" federal funds rate in positive territory. They are not just because of political pressure.

Are we concerned about Fed independence? Yes, monetary policy should not be controlled by politicians. But the Fed has only itself to blame. It did not act independently during 2008 or COVID when quantitative easing and zero percent rates provided the fuel for an unprecedented surge in government deficit spending. The inflation that followed (what we call political kryptonite) forced the Fed and politicians to accept higher interest rates and quantitative tightening. Politicians and the Fed may want to keep money easy, but markets have the final say.

To summarize, don't just watch interest rates. Watch the money supply too. For now, we think some modest cuts in short-term rates are warranted. But a surge in the M2 measure of money, if it happens, would change our minds. The Fed often claims to be "data dependent." In a better world, the money supply would be a major part of the data they are dependent on.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-23 / 7:30 am	Q2 Current Account Balance	-$256.3 Bil	**-$226.8 Bil**		-$450.2 Bil
9-24 / 9:00 am	New Home Sales – Aug	0.650 Mil	**0.650 Mil**		0.652 Mil
9-25 / 7:30 am	Initial Claims – Sep 20	234K	**235K**		231K
7:30 am	Q2 GDP Final Report	+3.3%	**+3.3%**		+3.3%
7:30 am	Q2 GDP Chain Price Index	+2.0%	**+2.0%**		+2.0%
7:30 am	Durable Goods – Aug	-0.3%	**-0.2%**		-2.8%
7:30 am	Durable Goods (Ex-Trans) – Aug	0.0%	**-0.3%**		+1.0%
9:00 am	Existing Home Sales – Aug	3.960 Mil	**3.940 Mil**		4.010 Mil
9-26 / 7:30 am	Personal Income – Aug	+0.3%	**+0.3%**		+0.4%
7:30 am	Personal Spending – Aug	+0.5%	**+0.4%**		+0.5%