First Trust
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Repudiating Milton Friedman

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Milton Friedman taught the world that the "transmission mechanism" for central bank policy worked through the quantity of money – the amount of money injected into, or subtracted from, the economy.

It now appears many members of the Federal Reserve don't believe this anymore. According to Fed Chair Janet Yellen, the Fed plans on ending bond purchases later this year, and then, without unwinding QE, start to raise the federal funds rate. By moving this way, the Fed is making the case for a permanently larger balance sheet and hoping it can use interest rates to manipulate economic activity.

But if banks expect excess reserves to stay in the system longer, perhaps even permanently, it is almost certain they will become more aggressive about lending even as they move up their expectations of when and how much short-term rates will rise. This, in turn, would boost the money supply sharply, driving up asset prices, economic activity and inflation in the months and years ahead.

Historically, most Fed watchers (including us), have talked in terms of the federal funds rate when communicating about Fed policy. But it's not because short-term rates are important by themselves, but because short rates rise and fall as the Fed manipulates the supply of reserves. A lower interest rate typically means more money growth and therefore more liquidity in the economy. Interest rates are a way of measuring money growth, like the mercury level in a tube measures temperature.

Quantitative Easing (QE) has complicated things. The Fed built massive excess reserves in the banking system by buying bonds and creating deposits to pay for them. And with so many excess reserves in the system, the overnight federal funds rate has been pushed to near zero.

Normally, these deposits would have resulted in a surge of lending (in turn, multiplied by the banking system), which would have boosted the M2 money supply. However, banks have been unwilling to use the lending capacity created by the new deposits.

This has happened for many reasons. First, banks are reluctant to lend when the Fed made it clear for years that the extra deposits were temporary. Second, Dodd-Frank hyper-regulation and new capital standards have squeezed banks' desire to leverage their balance sheets. Third, artificially low interest rates make it less attractive to lend.

The result: the Monetary Base has grown at a 32% annualized rate since September 2008, but the M2 money supply has only grown at a 6.7% rate. And as Milton Friedman taught us, it's M2 that matters, not the monetary base. That's why inflation has remained low.

As we discussed last week, with $2.6 trillion in excess reserves in the banking system, the Fed can't control the federal funds rate as it did prior to 2008 – using supply and demand pressures – by adding or subtracting reserves. One major problem is that, by law, the Fed can't pay interest on the reserves held by Government Sponsored Enterprises (GSEs) like Fannie Mae and Freddie Mac. So, these firms lend their reserves to other banks at a lower rate than the Fed is paying banks on reserves.

If the Fed lifts the interest rate it pays banks on reserves, the GSEs might charge more and boost rates, or they might not. As a result, the Fed is experimenting with a system of "repos" – where the Fed, in effect, would borrow the excess reserves of the GSEs at set interest rates. Using this new tool, the Fed will try to manipulate short-term interest rates throughout the financial system.

This gets around the law that says GSEs can't earn interest on reserves, and it will probably lift the federal funds rate. However, it still does *not* fix the problem of massive excess reserves in the system and, more importantly, it telegraphs that the Fed is willing to let excess reserves sit in the system for much longer.

Banks, in response, will likely become more willing to boost lending. And right on cue, commercial and industrial (C&I) loans have grown at a 23% annualized rate in the past two months, while the M2 money supply has jumped to a 9% growth rate.

We expect this to continue. Money growth should accelerate further and, because the Fed believes Friedman was wrong, or because it thinks GDP needs to rise significantly to get to potential, it will allow this to happen. As a result, that sugar high

caused by Fed policy we have heard about for so long, looks like it may finally arrive.

The downside of all this is palpable. If money growth takes off and threatens inflation, the Fed will attempt to stop it by raising interest rates. The hope will be that by raising rates, banks would view loans as less attractive than holding excess reserves. But, if short-term rates go up, so will other rates and banks would still have an incentive to boost loans.

If the Fed finds itself in this cycle, it could be forced to raise rates faster and further than it would have in the past. Or, the Fed may start operating like China's central bank, which means it would regulate loan growth or use other means of central control.

In the end, it is excess reserves that are the real problem, not the level of interest rates. Milton Friedman was not wrong, and trying to run a central bank like a regulatory body creates big risk.

The bottom line is that there appears to be an increase in liquidity – potentially a large one – heading the economy's way. That's good for stocks over the next year, or two, but after that, if a bubble forms, the dangers will rise appreciably. Stay tuned.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-31 / 8:45 am	Chicago PMI – Mar	59.5	**58.3**	55.9	59.8
4-1 / 9:00 am	ISM Index – Mar	54.0	**52.8**		53.2
9:00 am	Construction Spending – Feb	+0.1%	**-0.2%**		+0.1%
afternoon	Total Car/Truck Sales – Mar	15.8 Mil	**15.8 Mil**		15.3 Mil
afternoon	Domestic Car/Truck Sales - Mar	12.3 Mil	**12.3 Mil**		12.0 Mil
4-2 / 9:00 am	Factory Orders – Feb	+1.2%	**+1.5%**		-0.8%
4-3 / 7:30 am	Initial Claims - Mar 29	319K	**315K**		311K
7:30 am	Int'l Trade Balance – Feb	-$38.5 Bil	**-$38.0 Bil**		-$39.1 Bil
9:00 am	ISM Non Mfg Index – Mar	53.5	**53.4**		51.6
4-4 / 7:30 am	Non-Farm Payrolls - Mar	200K	**205K**		175K
7:30 am	Private Payrolls – Mar	194K	**205K**		162K
7:30 am	Manufacturing Payrolls – Mar	6K	**6K**		6K
7:30 am	Unemployment Rate – Mar	6.6%	**6.6%**		6.7%
7:30 am	Average Hourly Earnings – Mar	+0.2%	**+0.1%**		+0.4%
7:30 am	Average Weekly Hours – Mar	34.4	**34.4**		34.2

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.