First Trust
Monday Morning OUTLOOK
May 12th, 2014

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Federal Reserve Gone Wild

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The Fed has massively increased the size of its balance sheet, from roughly $850 billion in 2008 to its current $3.96 trillion. Quantitative Easing was accomplished by having the Fed buy bonds and pay for them by "creating" excess bank reserves – reserves above and beyond those that are required.

Now it looks like the Fed will finish tapering and then raise interest rates without shrinking its balance sheet. In this way, the Fed is behaving like any other government agency, not wanting to shrink again after growing during a crisis. But, in order to make this work, the Fed will eventually have to pay banks a high enough interest rate to incentivize them to keep excess reserves from turning into inflationary money growth.

However, not just banks hold reserves. Fannie Mae, Freddie Mac and some Federal Home Loan Banks hold reserves, too. But the "Financial Services Regulatory Relief Act of 2006," only gave the Fed the legal right to pay interest on balances "maintained at a Federal Reserve Bank <u>by or on behalf of a depository institution</u>." In other words…by law, the Fed can't pay Fannie Mae or the others interest on reserves.

As a result, the money the Fed has injected into these institutions is a potential source of inflation if they lend their reserves to banks. So the Fed has dreamed up a new program of "reverse repos," where it temporarily lends GSEs (and some money market funds) Treasury bonds with a promise to buy them back at a higher price in the future.

The price difference is an implied interest rate and by doing this the Fed is paying a higher rate today than these institutions can earn by buying 1, 3, or 6-month T-bills. The Fed is trying to mop up excess liquidity in the system so the money supply doesn't inflate.

But this flouts the law written by Congress. In effect, by coloring outside the legal lines, the Fed is paying interest on reserves to "non-banks." The Fed hopes this operation lets it have its cake (a large balance sheet) and eat it too (no rapid money growth).

In addition to undermining the rule of law, the practice is fraught with danger. If profitable lending opportunities accelerate, then, as the Fed tries to mop up excess reserves, it will be forced to raise interest rates higher and higher as an incentive for banks not to lend. Otherwise, if banks feel they can lend money to the private sector more profitably than they can lend to the Fed, they will not participate in the repo market.

This can cause the equivalent of an "arms race" in the financial system, where interest rates must be raised faster and further than the markets want in order to keep the lid on inflation and bank lending.

Rather than flout the law, the Fed should be looking for ways to unwind QE. It's time has come and gone. The Fed is too big – much bigger than Congress (The Law of The Land) ever wanted.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-13 / 7:30 am	Retail Sales – Apr	+0.4%	**+0.3%**		+1.2%
7:30 am	Retail Sales Ex-Auto – Apr	+0.6%	**+0.6%**		+0.7%
7:30 am	Import Prices – Apr	+0.4%	**+0.4%**		+0.6%
7:30 am	Export Prices – Apr	+0.3%	**+0.2%**		+0.8%
9:00 am	Business Inventories – Mar	+0.4%	**+0.4%**		+0.4%
5-14 / 7:30 am	PPI – Apr	+0.2%	**+0.2%**		+0.5%
7:30 am	"Core" PPI – Apr	+0.2%	**+0.1%**		+0.6%
5-15 / 7:30 am	Initial Claims – May 10	320K	**322K**		319K
7:30 am	CPI – Apr	+0.3%	**+0.3%**		+0.2%
7:30 am	"Core" CPI – Apr	+0.1%	**+0.1%**		+0.2%
7:30 am	Empire State Mfg Survey – May	5.3	**4.9**		1.3
8:15 am	Industrial Production – Apr	+0.1%	**+0.0%**		+0.7%
8:15 am	Capacity Utilization – Apr	79.2%	**79.1%**		79.2%
9:00 am	Philly Fed Survey – May	14.3	**14.3**		16.6
5-16 / 7:30 am	Housing Starts – Apr	0.980 Mil	**0.973 Mil**		0.946 Mil
8:55 am	U. Mich Consumer Sentiment- May	84.5	**84.5**		84.1