First Trust
Monday Morning OUTLOOK
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Low Inflation Is No "Mystery"

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Last week, at her press conference, Federal Reserve Chair, Janet Yellen said continued low inflation was a "mystery."

She's referring to Quantitative Easing (QE) and the lack of the economic evidence that it worked. The Fed bought $3.5 trillion of bonds with money it created out of thin air in an extraordinary "experiment" to avoid repeating the mistakes of the deflationary Great Depression. Milton Friedman was the leading scholar in this arena, proving the damage done by a shrinking money supply during the 1930s.

The money supply is a "demand-side" economic tool. A lack of money inhibits demand, while a surplus of money (more than the economy needs to grow) can cause inflation. The idea of QE (which has been tried unfruitfully for more than a decade in Japan) was to boost "demand-side" growth. And, yet, inflation and economic growth have both been weak. In other words, demand did not accelerate.

So forgive us for asking, but after unprecedented expansion of banking reserves and the Fed balance sheet, with little inflation, is it really a "mystery?" Or, is it proof of what we believed all along: QE didn't work?

We get it. Just the fact that the US economic recovery started in 2009 and stock prices went higher is all some need to convince themselves that QE worked. But no one knows what would have happened without QE.

Back in 2008, even Janet Yellen knew there were problems with QE. During a December 2008 Fed meeting, she said there were "no discernible economic effects" from Japanese QE. Back then she was President of the San Francisco Fed and this was said during internal debates about whether to do QE. Today she leads the Fed and bureaucracies can never admit failure. So, the lack of inflation becomes a "mystery."

Conventional Wisdom is so convinced that QE worked, it can't see anything as a failure. QE supposedly pushed up stock prices and drove down interest rates, while at the same time boosting jobs.

As for the lack of demand-side growth, the explanations are confusing. Yellen says low inflation is a mystery, others say it's because of new technologies, global trade, and rising productivity. Slow real GDP growth is blamed on global trade, a Great Stagnation in productivity and the lack of investment by private companies. QE gets credit for the things that went up, but things that didn't are explained away, denied, or determined to be mysteries.

We have promoted an alternative narrative that agrees with the 2008 Janet Yellen – QE didn't work. It flooded the banking system with cash. But instead of boosting Milton Friedman's key money number (M2), the excess monetary base growth went into "excess reserves" – money the banks hold as deposits, but don't lend out. Money in the warehouse (or in this case, credits on a computer) doesn't boost demand! This is why real GDP and inflation (nominal GDP) never accelerated in line with monetary base growth.

The Fed boosted bank reserves, but the banks never lent out and multiplied it like they had in previous decades. In fact, the M2 money supply (bank deposits) grew at roughly 6% since 2008, which is the same rate it grew in the second half of the 1990s.

So, why did stock prices rise and unemployment fall? Our answer: Once changes to mark-to-market accounting brought the Panic of 2008 to an end, which was five months after QE started, entrepreneurial activity accelerated. New technology (fracking, the cloud, Smartphones, Apps, the Genome, and 3-D printing) boosted efficiency and productivity in the private sector. In fact, if we look back we are astounded by the new technologies that have come of age in just the past decade. These new technologies boosted corporate profits and stock prices and, yes, the economy grew too.

The one thing that did change from the 1990s was the size of the government. Tax rates, regulation and redistribution all went up significantly. This weighed on the economy and real GDP growth never got back to 3.5% to 4%.

Occam's Razor – a theory about problem solving – says, when there are competing hypothesis, the one with the "fewest assumptions" is most likely the correct one.

The Fed narrative assumes QE worked and then uses questionable economics to explain away anything that does not fit that theory. It blames "mysterious" forces, both strong and weak productivity and claims business under-invested. We've never understood the weak investment argument; why would business leave opportunities on the table by not investing?

Our narrative is far simpler. It looks at M2 growth, gives credit to entrepreneurs, and blames big government. After all, the US economy grew rapidly before 1913 when there was no Fed, and during the 1980s and 90s, when Volcker and Greenspan were not doing QE. And history shows that inventions boost growth, while big government and redistribution harm it. Because it has the fewest assumptions, Occam's Razor suggests this is the more likely hypothesis.

The Fed has never fracked a well or written an app. We understand that government bureaucracies want to take credit for everything. But, in spite of record-setting money printing, inflation did not rise. Prices are measured in dollars, so if those dollars had actually entered the economy, prices in dollar terms would have gone up. They didn't, which clearly says that money didn't enter the economy and QE didn't work as advertised.

Some say that's because the money went into financial assets, but if that was the case the P-E ratio for the S&P 500 would be through the roof. But because earnings have risen so sharply, the P-E ratio is well within historical averages based on trailing 12-month earnings and relative to bond yields.

We also understand that entrepreneurship is a "mystery" to some people because they can't do it. Most people can't change the world the way entrepreneurs can, but that doesn't mean that by rearranging the assets of an economy in a different way, entrepreneurs don't create new wealth.

By claiming that low inflation is a "mystery" the Fed is admitting it doesn't understand the mechanics of QE. Yet, it is perfectly willing to allow people to think QE is what saved the economy. This is teaching an entire generation of young people, who in many cases don't study economic history, that growth requires government intervention. The only "mystery" is why they would allow this to happen.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-26 / 9:00 am	New Home Sales – Aug	0.585 Mil	**0.581 Mil**		0.571 Mil
9-27 / 7:30 am	Durable Goods – Aug	+0.9%	**+1.0%**		-6.8%
7:30 am	Durable Goods (Ex-Trans) – Aug	+0.3%	**+0.1%**		+0.6%
9-28 / 7:30 am	Initial Claims – Sep 23	270K	**260K**		259K
7:30 am	Q2 GDP Final Report	3.0%	**3.1%**		3.0%
7:30 am	Q2 GDP Chain Price Index	1.0%	**1.0%**		1.0%
9-29 / 7:30 am	Personal Income – Aug	+0.2%	**+0.2%**		+0.4%
7:30 am	Personal Spending – Aug	+0.1%	**+0.1%**		+0.3%
8:45 am	Chicago PMI - Sep	58.7	**59.1**		58.9
9:00 am	U. Mich Consumer Sentiment- Sep	95.3	**95.3**		95.3