Monday Morning Outlook

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Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-27 / 9:00 am	Jan New Home Sales	1.288M	1.300M		1.269M
2-28 / 7:30 am	Q4 Real GDP: Preliminary	+1.5%	+1.6%		+1.1%
	Q4 GDP Price Index: Preliminary	+3.0%	+3.0%		+3.0%
9:00 am	Jan Existing Home Sales	6.60M	6.85M		6.60M
	Feb Chicago PMI	58.8	59.0		58.5
3-1 / 7:30 am	Jan Personal Income	+0.6%	+0.6%		+0.4%
	Jan Personal Consumption	+1.0%	+1.5%		+0.9%
9:00 am	Feb ISM Manu Index	55.5	56.0		54.8
Sometime During	Feb Domestic Auto Sales	5.9M	6.2M		6.5M
the Day	Feb Domestic Light Truck Sales	7.4M	7.6M		7.7M
3-2 / 7:30 am	Initial Unemployment Claims	285K	286K		278K
3-3 / 7:30 am	Feb ISM Non Manu Index	58.0	58.5		56.8

Monetary Policy Misunderstanding

Monetary policy has always been an arcane topic, but year after year, fewer seem to really grasp how it works. Part of the reason for this is that the Fed targets interest rates these days and not the money supply like it did back in the 1970s.

As a result, most people think of monetary policy as changes in interest rates. But, the Fed does not directly control the federal funds rate. It controls money. Only by manipulating the money supply can it change the level of interest rates.

To do this, the Fed buys and sells bonds, from or to, the banking system. This adds or subtracts reserves. If the Fed wants rates to go up, it sells bonds or subtracts reserves. To push rates down, it buys bonds or adds reserves. Once the Fed has established an interest rate target, it then manages the money supply to match demand at the target rate.

Milton Friedman proved that it was changes in the money supply that impacted the economy, not changes in interest rates. When money growth accelerates, the economy accelerates, when money growth slows, so does the economy.

One reason Friedman's teachings have been forgotten is that changes in the money supply immediately impact interest rates, but there is a lag of 6 to 9 months before the economy responds. As a result, it looks like interest rates impact growth when, in fact, both rates and the economy are responding to money – rates first, the economy second.

Unfortunately, two factors (bank deregulation and globalization) have undermined the usefulness of the money supply data as a forecasting tool. The old relationships between money and the economy just don't work anymore.

As a result, economists who believe in Freidman (including the authors of this piece) are forced to watch interest rates. But we do not watch nominal rates. We watch real (or inflation adjusted) interest rates. When the Fed is not supplying enough money to the banking system, real rates tend to be high. When the Fed is adding excess liquidity, real rates are low.

In 2002 and 2003, the real federal funds rate was negative – a rare and clearly accommodative Fed policy. Today, overall inflation is running near 4%, while "core" inflation rates are near 2%. Using either measure, the real federal funds rate remains low by historical standards, as are interest rates across the entire yield curve.

Because the Fed has hiked rates at 14 consecutive meetings (from 1% to 4.5%), many analysts fret the Fed has tightened too much. But with real rates still low, the evidence suggests that the money supply is growing at a rate that will continue to lift growth, not hinder it. Elevated commodity prices and a relatively weak dollar are confirming signals of this accommodative Fed policy, which make us more bullish on economic growth in 2006.

Week of March 6, 2006

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-6 / 9:00 am	Jan Factory Orders	-6.0%	-5.0%		+1.1%
3-7 / 7:30 am	Q4 Productivity: Revised	-0.3%	-0.2%		-0.6%
	Q4 Unit Labor Costs	+3.1%	+3.1%		+3.5%
3-9 / 7:30 am	Jan International Trade	-$67.0B	-$67.0B		-$65.7B
3-10 / 7:30 am	Feb Non-Farm Payrolls	+185K	+265K		+193K
	Feb Manufacturing Payrolls	+7K	+12K		+7K
	Feb Unemployment Rate	4.7%	4.7%		4.7%
	Feb Average Hourly Earnings	+0.5%	+0.4%		+0.4%
	Feb Weekly Hours	33.8	33.8		33.8

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