First Trust
Monday Morning OUTLOOK
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Fed Looking in Wrong Tool Shed

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Senior Economist*
Strider Elass – *Economic Analyst*
Andrew Hull – *Economic Analyst*

The Fed made history again last week when it specifically committed to near-zero short-term interest rates through at least mid-2013. This commitment was a first for the Fed, and while it can always renege, the bar for doing so is now very high.

The Fed also said it had discussed a "range of policy tools" to strengthen the economy. If they're the ones the Fed has been leaking to the media, count us as unimpressed.

One option would be to launch into a third round of quantitative easing, modeled after round two that ended in June. Trouble is, other than boosting commodity prices, QE2 had little visible affect on the real economy. The Fed says that QE lifted stock prices, but since P-E ratios have declined over the past few years, this appears to be the Fed trying to take credit for something it didn't do.

For instance, QE2 resulted in the Fed buying $600 billion in long-term securities. These assets were offset by liabilities which are made up of $600 billion in bank reserves (excess reserves). But, the banks already had $1 trillion in excess reserves when QE2 started. By the end of June, they had $1.6 trillion. In fact, excluding banks' excess reserves, the balance sheet of the Fed is now slightly smaller than when QE2 started. Buying even more securities from the banks and having them hold even more in reserves does not help the economy.

Another option is for the Fed to shift more of its portfolio away from short term Treasuries and toward long term Treasuries. The idea would be to make long term Treasuries more scarce and drive down their yields, helping reduce mortgage rates and rates on other loans.

But if this strategy could really work, why does the Fed have to do it? Why doesn't the Treasury Department itself issue less long-term debt and more short-term debt? Moreover, markets aren't dumb. If the Fed, or Treasury, orchestrates a supply-driven decline in the yields on long-dated Treasury securities, mortgage spreads over those yields, which are now extremely low by historical standards, could easily widen.

The third option that's gotten many Fed watchers attention is eliminating the interest the Fed pays banks for holding excess reserves, now 0.25%. At least here the Fed's talking about a policy shift that could actually change incentives. But a quarter point of reduction seems awfully small.

Rather than looking at the *supply* of funds available to banks to lend, the Fed needs to point its collective finger at Capitol Hill and the White House and say they need to enact more policies to boost the *demand* for credit. And the best way to do that is a set of policies that encourages more work effort and more innovation. It could start by pointing out the negative impact of Dodd-Frank, and could finish up by requesting a real reduction in spending and tax reform.

Ultimately, the Fed has to admit monetary policy cannot fix all problems. "Core" inflation is up at a 2.5% annual rate in the past six months, gold has set record highs and the dollar is weak. The Fed should fret about these things and put the blame for high unemployment on the Congress and the White House, where it belongs.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-15 / 7:30 am	Empire State Mfg Index - Aug	0.0	**2.0**	-7.7	-3.8
8-16 / 7:30 am	Housing Starts - Jul	0.600 Mil	**0.580 Mil**		0.629 Mil
7:30 am	Export Prices - Jul	+0.2%	**+0.2%**		+0.1%
7:30 am	Import Prices - Jul	-0.1%	**-0.1%**		-0.5%
8:15 am	Industrial Production - Jul	+0.4%	**+0.5%**		+0.2%
8:15 am	Capacity Utilization - Jul	77.0%	**77.0%**		76.7%
8-17 / 7:30 am	PPI - Jul	0.0%	**+0.1%**		-0.4%
7:30 am	"Core" PPI - Jul	+0.2%	**+0.2%**		+0.3%
8-18 / 7:30 am	CPI - Jul	+0.2%	**+0.1%**		-0.2%
7:30 am	"Core" CPI - Jul	+0.2%	**+0.2%**		+0.3%
7:30 am	Initial Claims - August 13	400K	**395K**		395K
9:00 am	Philly Fed Survey - Aug	4.2	**4.0**		3.2
9:00 am	Leading Indicators - Jul	+0.2%	**+0.6%**		+0.3%
9:00 am	Existing Home Sales - Jul	4.900 Mil	**5.000 Mil**		4.770 Mil

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