First Trust
Monday Morning OUTLOOK

630-517-7756 • www.ftportfolios.com February 29, 2016

Currency Mayhem

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

With both the European Central Bank (ECB) and the Bank of Japan moving to a Negative Interest Rate Policy (NIRP), conventional wisdom says the US dollar will continue to strengthen. After all, the Fed is tightening while everyone else seems to be working overtime to ease policy.

But this thinking may have it exactly backward. The experimental monetary policies of quantitative easing (QE), zero interest rates (ZIRP), and NIRP have a spotty record at best. There is little evidence they have worked. After all Japan has been doing QE since 2001 – so where are the fruits?

Moreover, it's very possible that negative interest rates will increase cash hoarding and thereby slow money growth. And if money growth slows in Europe and Japan, while it accelerates in the US, then the dollar may actually weaken, or at least not strengthen in any significant way.

As a result, hedging European or Japanese investments for currency risk could be a costly mistake. In addition, it would be another mistake to underestimate the earnings potential of multinational US corporations due to potential currency losses.

So, how can this make sense? First, the Federal Reserve is in the midst of an incredible monetary experiment that has never been done before.

From 1913 to 2008, when the Fed wanted to raise interest rates it reduced the amount of outstanding reserves by selling bonds to banks. But this time it really is different; banks have more reserves than they know what to do with. So instead, the Fed is offering to pay a slightly higher interest rate on current bank reserves. But it's a weak tool at best. Though the Fed has withdrawn some reserves from the banking system, there are still over $2 trillion in excess reserves system-wide.

In other words, the banking system is still awash in a massive amount of liquidity that can be turned into loans and an increased money supply. And as the Fed has lifted rates, both the M2 money supply (all deposits at all banks) and bank loans and leases have accelerated. In the three months ending in February, M2 has grown at a 6.9% annual rate versus just 5.6% in the past 12 months, while overall loans and leases have accelerated to a 9.8% growth rate in the past three months.

At the same time, there is a shortage of safes in Japan as consumers try to get cash out of banks where they may be charged interest, instead of receiving interest, in the future. At the margin this is happening in Europe as well. When people hold more cash, banks have fewer deposits, so the idea that these negative interest rates will force banks to lend and expand the money supply is suspect.

The big mistake investors are making is believing that central banks can actually manage economic growth. It's not true and, in fact, the conventional wisdom is causing investors to make big mistakes with what we can only call very simplistic monetary analysis. Don't always take things at face value.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-29 / 8:45 am	Chicago PMI – Feb	52.5	**52.2**	47.6	55.6
3-1 / 9:00 am	ISM Index – Feb	48.5	**48.2**		48.2
9:00 am	Construction Spending – Jan	+0.3%	**+0.1%**		+0.1%
afternoon	Total Car/Truck Sales – Feb	17.7 Mil	**17.7 Mil**		17.5 Mil
afternoon	Domestic Car/Truck Sales – Feb	13.9 Mil	**13.9 Mil**		13.8 Mil
3-3 / 7:30 am	Initial Claims – Feb 27	270K	**272K**		272K
7:30 am	Q4 Non-Farm Productivity	-3.0%	**-2.4%**		-3.0%
7:30 am	Q4 Unit Labor Costs	+4.4%	**+3.3%**		+4.5%
9:00 am	ISM Non Mfg Index – Feb	53.1	**52.7**		53.5
9:00 am	Factory Orders – Jan	+2.1%	**+1.0%**		-2.9%
3-4 / 7:30 am	Non-Farm Payrolls – Feb	195K	**217K**		151K
7:30 am	Private Payrolls – Feb	185K	**212K**		158K
7:30 am	Manufacturing Payrolls – Feb	0	**-3K**		29K
7:30 am	Unemployment Rate – Feb	4.9%	**4.9%**		4.9%
7:30 am	Average Hourly Earnings – Feb	+0.2%	**+0.2%**		+0.5%
7:30 am	Average Weekly Hours – Feb	34.6	**34.6**		34.6
7:30 am	Int'l Trade Balance – Jan	-$44.0 Bil	**-$44.0 Bil**		-$43.4 Bil