First Trust
Monday Morning OUTLOOK
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It's Still the Fed, And It's Not Magic

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We hate to do this and we hope we don't put you to sleep so early in the week, but it's time to talk about monetary policy. Specifically, the "transmission mechanism" of monetary policy.

The Federal Reserve has convinced itself, and many others, that it has ultimate control over the economy.

But there is little evidence this is true. There is absolutely no reason to think the monetary transmission mechanism – the one taught to us by Milton Friedman and Irving Fisher – has changed. Interest rates and the yield curve are not monetary policy. Monetary policy is about money creation, and that's it.

The Fed either creates or destroys bank reserves. It does this by buying or selling bonds, to or from, banks. When the Fed buys bonds, it pays banks for those bonds by creating new deposits. Banks then take those reserves, and through the money multiplier lending process, create growth in the money supply. If the Fed sells bonds to banks, the process reverses and money tightens.

Adding reserves to the system drives their cost, short-term interest rates, down. If the Fed makes reserves scarce, short-term rates are driven up.

This is why so many people think rising short-term interest rates signal tight money, while falling short-term rates signal easy money. But, it's not the rates that really matter, it's the money. When the Fed prints money, it boosts spending because there is more money to spend, not because interest rates are lower. It's the money that matters, not the rates.

A perfect example of this is happening right now. The Fed is close to its second rate hike since starting quantitative easing. But rate hikes don't tighten monetary policy these days, because the Fed is not shrinking the actual amount of bank reserves.

Even if the Fed hikes rates this year, it has signaled it has no intention of selling any of the bonds it owns. As a result, banks will have $2.2 trillion in excess reserves before the Fed hikes rates and $2.2 trillion in excess reserves after it hikes rates.

Yes, it is more costly to borrow at 0.75% or 1.0% rates than at 0.5%, but who really believes that these still low rates will inhibit borrowing? After all, the "core" consumer price index is up 2.3% in the past year. Real rates are negative.

The same is true for the long-end of the yield curve, where yields are very, very low as well.

The Federal Reserve is currently involved in one of its most protracted periods of "mission creep" in its 103-year history. It has printed massive amounts of new money, but it has also supported an incredible array of new bank regulations at the same time. As a result, all that new money has been clogged up in the system and has not created inflation or an acceleration in economic activity.

In other words, monetary policy has become less effective as the Fed's balance sheet has grown. This is also true for the European and Japanese Central Banks, as well. Negative interest rates are back-firing because you can't force banks to lend when few good loans are available and as consumers choose to hold cash instead of bank deposits.

The bottom line is that the Fed has no new power over the money supply. Like gravity or the speed of light, wishing things were different doesn't make it true. Even though the Fed has new found political powers, it has no more "actual" power over the economy than it did in the 1960s. It's about money, not rates, and the debate about when rates may rise is basically a waste of time.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-26 / 9:00 am	New Home Sales – Aug	0.600 Mil	**0.584 Mil**	0.609 Mil	0.654 Mil
9-27 / 9:00 am	Consumer Confidence – Sep	99.0	**98.6**		101.1
9-28 / 7:30 am	Durable Goods – Aug	-1.5%	**-1.8%**		+4.4%
7:30 am	Durable Goods (Ex-Trans) – Aug	-0.5%	**-0.7%**		+1.3%
9-29 / 7:30 am	Initial Claims – Sep 24	260K	**259K**		252K
7:30 am	Q2 GDP Final Report	1.3%	**1.3%**		1.1%
7:30 am	Q2 GDP Chain Price Index	2.3%	**2.3%**		2.3%
9-30 / 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	52.0	**51.5**		51.5
9:00 am	U. Mich Consumer Sentiment- Sep	90.0	**89.8**		89.8