First Trust
Monday Morning OUTLOOK

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The Fed is A Proxy for Government

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Well, that was fun! The GOP's attempt to reform healthcare hit a brick wall of politics. Conservative Republicans wanted to completely "repeal" Obamacare, while moderates and leaders were willing to keep much of it as long as it cost less. Moving one way or the other lost too many votes. Democrats refused to participate. So, the bill died.

The stock market rose when it looked like Speaker Ryan's bill would pass, and fell when prospects faded. But US stocks remain undervalued. Nothing, other than politics, has changed and we expect equity values to continue to rise.

There is a huge debate in America these days about the role of government in the economy. This debate reached a fever pitch following the Economic Panic of 2008.

Republicans pushed TARP, which basically said "free markets cause problems and government must be used to fix them." President Obama used that shift in philosophy to suggest government should run healthcare.

At the same time, the Federal Reserve cut interest rates to zero and massively increased the size of its balance sheet. The key question is whether this is a permanent increase in the size and scope of government or can it be rolled back? Will the Fed shrink its balance sheet?

The Fed's balance sheet grew from $800 billion before 2008 to $4.4 trillion today. From 6% to 24% of GDP. It's a bigger share of GDP today than it was during the Great Depression.

Quantitative Easing and the size of the Fed's balance sheet has completely changed the way monetary policy is managed. It used to be that the Fed changed the size of its balance sheet to move interest rates. If it wanted rates to fall, it would buy bonds (increase the size of its balance sheet) by printing new money. That money would boost bank reserves and force the federal funds rate lower. If it wanted rates to rise, it would sell bonds, shrinking the amount of reserves, driving up rates as banks competed for a smaller pool.

These days, with over $2 trillion of "excess reserves," the Fed manages monetary policy by changing the rate that it will pay banks to sit on those excess reserves. The idea being that if the Fed pays enough then banks won't lend them out. In other words, the Fed thinks it can control the money supply by encouraging or punishing banks. This is the same idea behind the negative interest rate experiments in Europe and Japan.

The world is still in the very early stages of this experiment and no matter what anyone says, no one knows if it will work or not. We believe that it's failing. For example, negative interest rates did not boost growth in Europe.

Quantitative Easing did not boost inflation in the US, nor did it boost economic growth. The reason: with one hand the Fed was shoveling money into the economy, but with the other hand it was regulating banks like never before. Higher capital requirements, Dodd-Frank, and heavy-handed regulation kept banks from expanding loans at the same time they had more reserves and capital.

If the Trump Administration reduces regulation, the money supply will increase even if the Fed pays more to banks for holding reserves. The reason – loans are more profitable than Fed interest rates as long as the yield curve is upward sloping. And as long as excess reserves exist, banks can increase loans and the money supply, which means inflation is a threat and the yield curve will likely remain upward sloping.

In other words, an upwardly sloping yield curve makes it virtually impossible to get a tight monetary policy as long as the Fed allows excess reserves. In addition, with the Fed's balance sheet so large, even an inversion does not necessarily signal as much monetary tightness as in the past.

At the same time, the US federal government will find it virtually impossible to ever balance the budget again without getting control of spending. The government has managed to make itself so big that its decisions in the next few years will have implications for decades. Leaving excess reserves in the system is economically dangerous, just like not reforming entitlements.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-28 / 9:00 am	Consumer Confidence – Mar	114.0	**114.1**		114.8
3-30 / 7:30 am	Initial Claims - Mar 26	246K	**247K**		261K
7:30 am	Q4 GDP Final Report	2.0%	**1.9%**		1.9%
7:30 am	Q4 GDP Chain Price Index	2.0%	**2.0%**		2.0%
3-31 / 7:30 am	Personal Income – Feb	+0.4%	**+0.4%**		+0.4%
7:30 am	Personal Spending – Feb	+0.2%	**+0.2%**		+0.2%
8:45 am	Chicago PMI – Mar	56.9	**57.1**		57.4
9:00 am	U. Mich Consumer Sentiment- Mar	97.6	**97.6**		97.6

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.