First Trust
Monday Morning OUTLOOK

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Senior Economist*
Bryce Gill – *Economist*

630-517-7756 • www.ftportfolios.com March 22, 2021

The Fed, Regulation, and MMT - Irresponsible

You've got to hand it to the Federal Reserve. With the cleverness of a seasoned head coach – think Jim Boeheim leading Syracuse in the NCAA basketball tournament – they figured out how to accomplish a great deal while making it look like they didn't have many tools at their disposal.

The market keeps expecting the Fed to bow to pressures to lift rates, and the Fed knows that it can't keep interest rates at zero forever. But it wants to keep them there for as long as it can. So, how do they do that? Well, one way is to forecast higher inflation and real GDP growth so that if (and when) it occurs, you can say "well, that doesn't surprise us at all."

Follow the bouncing ball. At its last meeting, the Fed raised its 2021 real GDP forecast to 6.5% growth, while it expects 2.4% inflation (and argues that it *wants* inflation to rise above 2%), and unemployment is forecast to fall below 4% in 2022. Despite that outlook, most Fed members are still projecting no increases in short-term interest rates until 2024 or beyond.

As a result, the economy can accelerate to its fastest growth rate since the early 1980s and inflation can move above the Fed's 2% target, all while the Fed sits back and yawns.

Of course, the bond market has a say in things, too. Rapid growth and higher inflation could push up long-term interest rates even further, and at that point the "bond vigilantes" may force the Fed's hand. But the Fed feels confident that it has the tools to deal with this…specifically, asset purchases.

Right now, the Fed is buying $80 billion of Treasury debt each month and $40 billion of mortgage-backed securities. The Fed could raise the total every month, it could shift purchases to longer-dated Treasury debt, or it could buy fewer mortgages and more Treasuries. After all, the housing market is booming, so the Fed can withdraw support.

We think, in the end, the Fed will change its mix of bond buying *and* be pressured to lift rates before it now expects. Either way, the change in its forecast has bought some time before it does either. And that's good, because the Fed is now wrestling with an entirely different issue. In order for the Fed to operate within an economic policy that certainly looks like Modern Monetary Theory, it must purchase trillions of dollars of government debt.

While many think the Fed can do this all on its own, it actually needs the US banking system to help. Big banks, and their primary dealers, buy bonds from the Treasury and then the Fed buys these bonds from banks by creating new reserves. So, the banks end up holding either the Treasuries – if the Fed doesn't buy them all – or the new reserves (deposits) that the Fed created to purchase them.

Historically, no one cared how many Treasury bonds or reserves that the banks held because they are the most credit-worthy assets on the face of the earth. Regulators only worried about personal or business loans or risky bond debt that banks held because, as we saw in 2008, when these loans start to default the banking system can get in trouble.

After 2008, regulators and politicians made banks hold more capital so that shareholders, not taxpayers, would be on the hook for loan losses. But they didn't stop there. The Fed invented something called the Supplementary Leverage Ratio (SLR), which is a rule requiring banks to hold 5% capital against ALL their assets – including Treasury bonds and reserves.

In normal times, this new rule had little effect. But last year, when politicians decided to run up a $3 trillion dollar deficit to offset economic damage from the COVID shutdowns, the Fed stepped in and bought over $2 trillion of assets. This money flowed into the banking system, threatening to overwhelm banks with new money. If loan losses increased because of forced business closures, at the same time banks had to hold more Treasury debt and reserves because of Congressional and Fed actions, they might have breached the SLR capital requirements.

So, what did government do? It relaxed the SLR, and exempted banks from holding capital against Treasury debt and reserves. We don't think banks should need to hold this extra capital against risk-free assets, especially when it is the government forcing them to hold them.

Unfortunately, late last week, at the urging of progressive lawmakers, the Fed announced it would *not* extend the exemption beyond March 31. Senator Elizabeth Warren said "The banks' requests for an extension of this relief appear to be an attempt to use the pandemic as an excuse to weaken one of the most important postcrisis regulatory reforms…" But this really isn't true. While we can understand holding extra reserves to offset exposure to risky assets (and regulators can raise this requirement whenever they want), it makes no sense when required of non-risky assets.

What we think is really going on is that banks are making money by holding risk-free Treasury assets and it is Modern Monetary Theory that is forcing these bonds into the banking system. When the Federal Government spends money, and the Fed pays for it by printing new money, it expands the private banking system in the United States.

Attempting to take away any profits from banks for holding these Treasury bonds reduces returns for shareholders. And if banks eventually hit these new liquidity rule levels, they must stop accepting deposits, stop making business loans, or stop buying Treasuries.

The fear that banks may stop buying Treasuries caused a jump in longer-term interest rates last week (the 10-year Treasury jumped to over 1.7%). At the same time, bank stock prices fell. It's simple math. If these banks are forced to hold more capital, then returns to shareholders will fall as they stop buybacks, limit dividends, or even issue more shares.

We think all this was a short-term over-reaction. Right now, banks have enough excess capital to keep absorbing federal debt. According to a Bloomberg News article, banks have roughly $200 billion in capital above the 5% required.

If we apply a 5% requirement to $200 billion, technically the banks could absorb another $4 trillion in Treasuries, reserves, or loans. But, remember, the government just passed another $1.9 trillion "rescue" bill which must be financed by borrowing, and the Fed is scheduled to buy $1.4 trillion in assets this year. On top of this, team Biden is saying it wants to pass another $2 trillion to $4 trillion infrastructure bill. And while this is going on, we expect real GDP to expand by 6% this year, which will certainly increase the demand for business loans.

In other words, as the future unfolds, the cushion of capital will be absorbed. Banks have said they face no near-term problems and we don't disagree. Lending can continue as the economy picks up. But in the longer-term this regulation threatens to undermine the government's desire to spend more and more. That's what makes the progressive push to renew the SLR a bit of a mystery. Why interfere with borrowing?

Maybe, and we are not trying to be conspiracy theorists here, progressives want to revert to a national bank, or have regulators gain even more controls over the private banking system than they already have.

Evidently, all of this may become moot. The Federal Reserve has said that it is reviewing these rules and will likely make modifications in the near future. While we expect the Fed to escape the dangerous downside to these new rules, we are also cognizant of the fact that the US has entered an unprecedented period of government regulation and growth.

Former Clinton Treasury Secretary Larry Summers has called it "the least responsible fiscal macroeconomic policy we've had for the last 40 years." We think he is right about the irresponsibility, but wrong about the time period. It's not the past 40 years, it's the entire history of the United States.

In the near-term, investors are safe from the stagflation we saw 40 years ago. But, as 2023 rolls around we aren't so sure. Stay positive for now, the worries are long-term.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-22 / 9:00 am	Existing Home Sales – Feb	6.500 Mil	**6.320 Mil**	6.220 Mil	6.690 Mil
3-23 / 9:00 am	New Home Sales – Feb	0.875 Mil	**0.872 Mil**		0.923 Mil
3-24 / 7:30 am	Durable Goods – Feb	+0.7%	**-0.1%**		+3.4%
7:30 am	Durable Goods (Ex-Trans) – Feb	+0.6%	**-0.4%**		+1.3%
3-25 / 7:30 am	Initial Claims – Mar 21	730K	**735K**		770K
7:30 am	Q4 GDP Final Report	4.1%	**4.2%**		4.1%
7:30 am	Q4 GDP Chain Price Index	+2.1%	**+2.1%**		+2.1%
3-26 / 7:30 am	Personal Income – Feb	-7.2%	**-5.7%**		+10.0%
7:30 am	Personal Spending – Jan	-0.8%	**-0.7%**		+2.4%
9:00 am	U. Mich Consumer Sentiment- Mar	83.6	**83.0**		83.0