First Trust
ECONOMIC RESEARCH REPORT

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The Monetary Surge Continues to Ebb

We've told people to watch the M2 measure of money in order to understand whether inflation will cool down or heat up. The Fed only releases this data on a monthly basis. They used to release it weekly, and we think not doing so robs the world of important information, nonetheless for now it is monthly.

Today the Fed released May data on the M2 money supply and from our point of view it was welcome news, signaling that the monetary surge propelling US inflation numbers to a four-decade high seems to be slowing. The amount of M2 money in circulation rose just 0.1% in May (after falling in April).

As a result, the 12-month change fell to 6.6%, the slowest growth rate since the pre-pandemic days of 2019. Six percent growth is what we would consider "normal" from a historical perspective, so this represents welcome progress. So far in 2022, the money supply has grown at a modest 3.1% annualized rate.

However, high inflation is likely to linger. The M2 measure of money grew at an 18% annualized rate in 2020-21, or roughly three times the "normal" rate, and it will take multiple years for the US economy to fully digest all that excess purchasing power even if the money supply slows in the year ahead. If the Fed really does want to achieve a soft landing for the US economy, the best option in our opinion is to somehow keep M2 growth at a below trend rate in the 2-4% range for the next few years.

It's worth noting that recent money supply growth is being affected by unusually large tax payments. In April the US Treasury posted a $308 billion surplus - the largest on record. This allowed the Treasury to shrink its own checking accounts. This caused April's M2 number to post a rare monthly decline and it clearly could have affected M2 in May as well. It's possible this is just a temporary factor holding back M2 growth rates, and the Treasury will certainly not run a surplus this year. We will get a clearer picture in the months ahead.

With the Fed having stopped expanding its balance sheet, there is still no guarantee that M2 will continue to decelerate. The only way to truly slow down the growth rate of M2 is by holding back loan growth in the private banking sector.

Unfortunately, simply raising short-term interest rates may not work. With so many excess reserves in the system, will banks just accept what the Fed is paying? What rate is high enough for them to slow lending, or even reverse it? Or will the Fed increase the burden of capital requirements and liquidity ratios to constrain banks? The Fed has completely moved away from the reserve scarcity model it used prior to quantitative easing in 2008. No one, not even the Fed knows how all this works in a world of overly abundant reserves. We will keep watching M2…but, at least for the moment, things appear to be moving in a direction that will bring down inflation in the years ahead.

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