First Trust
ECONOMIC RESEARCH REPORT

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

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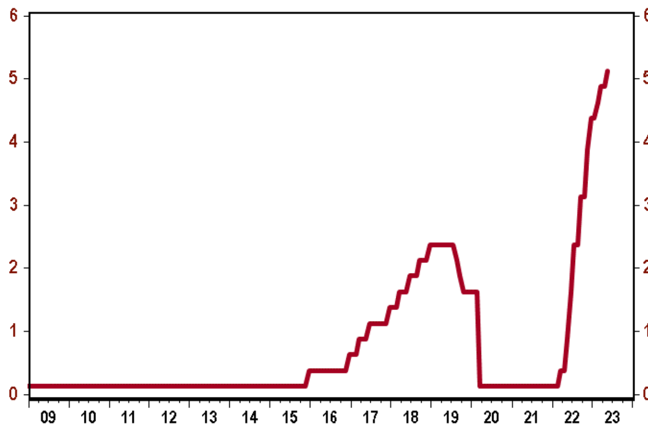
Has the Fed Paused?

The Fed raised short-term interest rates by another quarter percentage point today to a range of 5.00 – 5.25%, just like most analysts and investors expected. In addition, policymakers made changes to its official statement that hint that this rate hike might be the last of the cycle.

In particular, the Federal Reserve removed language from the previous statement that it "anticipates that some additional policy firming may be appropriate" and a reference to "future increases" in the target range. Now the emphasis in the statement is that further rate hikes "may be appropriate" with no reference to "future increases" in the target range. In reaction, the futures market is pricing in no more rate hikes this cycle and for cuts to start in September, with about three or four quarter-point rate cuts by the end of January 2024.



By contrast, we think inflation will remain more elevated than the Fed projects and that the Fed will likely raise rates at least one more time this cycle. In addition, we believe the process for starting rate cuts is further off than the futures market suggests. Chairman Powell himself, at the post-meeting press conference, poured cold water on the prospects of rate cuts, assuming the economy develops as the Fed expects.

Yes, headlines are full of stories about banking turmoil, but the Fed and FDIC have, at least temporarily, ring-fenced traditional banks, guaranteeing deposits in FDIC-insured accounts, potentially no matter how high. This will prevent bank runs, kicking the can down the road for future policymakers to deal with the problem. Meanwhile, although we believe a recession is coming it isn't here yet.

But investors need to understand that changes in short-term interest rates are not as important as what's happening to the M2 measure of the money supply. It is M2 that will tell us what the net effects of all the Fed's policies and the banking situation are. M2 soared more than 40% in the first two years of COVID, but plateaued last year and then started to decline; in the past eight months, M2 is down 4.1%, the steepest drop for any eight-month period since the Great Depression. If this continues through year end, it could generate a deeper recession and more forceful drop in inflation than we anticipate.

One key takeaway from today's meeting is that the Fed press, once again, failed to ask any questions about either the money supply or how the Fed is funding its operations when it's running at a prolonged loss, which is an unprecedented situation for the modern Fed. Talk about groupthink! Instead, we get pretty much the same three to five cookie-cutter questions asked several different ways.

The Fed remains all mixed up. The reason it's mixed up is because in the 2008-09 crisis it abandoned its long tradition of implementing monetary policy through scarce reserves and imposed a new policy based on abundant reserves. They didn't know where it was heading at the time; now we're finding out. The turmoil in the markets isn't over. We remain cautious on equities and think a recession is on the way.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Deputy Chief Economist*

Text of the Federal Reserve's Statement:

Economic activity expanded at a modest pace in the first quarter. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation remains elevated.

The U.S. banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 5 to 5-1/4 percent. The Committee will closely monitor incoming information and assess the implications for monetary policy. In determining the extent to which additional policy firming may be appropriate to return inflation to 2 percent over time,

the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. The Committee is strongly committed to returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; Lisa D. Cook; Austan D. Goolsbee; Patrick Harker; Philip N. Jefferson; Neel Kashkari; Lorie K. Logan; and Christopher J. Waller.

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 subjet to change without notice. This informaton does not constitute a solicitation or an ofer to buy or sell any security.