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*
**Nate Gerze, CFA** – *Economist*

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# Fed Still Evading Key Issues

Last Friday, Jerome Powell gave the Fed Chief's annual speech at the Kansas City Fed's 2025 meeting in Jackson Hole, WY. He said the balance of economic risks "may warrant" a policy stance adjustment. Stocks soared and the market immediately raised the odds on one 25 basis point cut in the federal funds rate on September 17th.

The Jackson Hole central banker confab always has a theme and this year's was "Labor Markets in Transition." What is so interesting to us about this is that apparently, at present, the only tool the Fed thinks it has in its arsenal is short-term interest rates, specifically the federal funds rate.

If you listened to Jerome Powell's speech (transcript here), that's all he talked about. Well, actually, he did talk some about tariffs, supply chains during the pandemic, immigration, and a few other issues far outside the Fed's responsibility. But the reason he talked about them is that they all may make the Fed want to change short-term rates.

What the Fed doesn't talk about is the money supply or the size of its balance sheet. At Jackson Hole, it didn't respond to Senators who think paying private banks roughly $200 billion a year to hold reserves and losing $100 billion per year is reason for concern. The Fed just ignores these questions.

Apparently, the Fed thinks changing short-term interest rates can impact, or influence, just about anything the economy throws its way. We won't argue that the federal funds rate is probably the most important financial market indicator in the world. The question is whether it is really the single most important influence on economic activity.

The Fed held interest rates near zero for seven years after 2008 and the US did not experience inflation and real economic growth remained relatively slow. It held interest rates near zero for two years during COVID and we ended up with 9% inflation and real growth remained slow. So maybe short-term interest rates are not quite as economically impactful as the Fed thinks they are. What's interesting is that the money supply did not accelerate after 2008, but it soared during COVID. If it were up to us, we would include the money supply in our analysis. The Fed doesn't.

And that brings us to the real announcement by Powell in his speech. The Fed is changing its "framework" for managing monetary policy. In 2020, Powell and the Fed decided that inflation should "average" 2% over time. For some strange reason the fact that inflation had only been about 1.5% per year in the previous ten years bothered the Fed.

We would call keeping inflation below 2% a victory, but the Fed decided this low inflation rate was an impediment to growth. So, to raise the "average rate" to 2% it could run inflation above that for some unknown time and by some unknown amount in future years to "makeup" for the lower inflation. The result: the highest inflation rate in 40 years and more volatility in long-term interest rates.

Now, until it decides to change again, the new framework will target 2% inflation. No more averaging. At the same time the Fed decided it will not worry so much when the labor market runs hotter than full-employment.

All of this sounds like an excuse to cut rates. What we really want is an explanation for why the Fed decided to increase the size of its balance sheet from $800 billion to $6.6 trillion…over a 7-fold increase; why it allowed the money supply to nearly triple between 2008 and 2025; and why it thinks hundreds of billions of dollars of losses on banks' books is OK today, but wasn't in 2008.

The 2008 change in monetary policy was one of the biggest changes in US monetary policy in history and the Fed behaves as if it never happened. By flooding the system with reserves, the Fed removed daily trading by market entities in the federal funds marketplace. The Fed "administers" the rate. We call it price fixing. Reporters don't ask about it. Central banks around the world have now become money-losing hedge funds and act as if it isn't happening.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 8-25 / 9:00 am | New Home Sales – Jul | 0.630 Mil | **0.625 Mil** | 0.627 Mil | 0.627 Mil |
| 8-26 / 7:30 am | Durable Goods – Jul | -3.8% | **-5.3%** | | -9.4% |
| 7:30 am | Durable Goods (Ex-Trans) – Jul | +0.2% | **+0.2%** | | +0.2% |
| 8-28 / 7:30 am | Initial Claims – Aug 23 | 230K | **231K** | | 235K |
| 7:30 am | Q2 GDP Preliminary Report | +3.1% | **+3.1%** | | +3.0% |
| 7:30 am | Q2 GDP Chain Price Index | +2.0% | **+2.0%** | | +2.0% |
| 8-29 / 7:30 am | Personal Income – Jul | +0.4% | **+0.5%** | | +0.3% |
| 7:30 am | Personal Spending – Jul | +0.5% | **+0.5%** | | +0.3% |
| 8:45 am | Chicago PMI – Aug | 46.0 | **44.9** | | 47.1 |