First Trust
Monday Morning OUTLOOK

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February 26, 2024

Watching the Fed

Every day this week, investors will get data on the economy. New home sales today, then capital investment, GDP, consumer incomes and spending, manufacturing, and auto sales are on the list. All of this will feed into the outlook for what the Federal Reserve might do with interest rates this year.

Pretty much everyone expects the Fed to cut rates this year, but expectations have changed. A month ago, the futures market was pricing in five or six twenty-five basis point (bps) rate cuts in 2024 (125 - 150 bps in total); now the market is pricing in three or four (75 - 100 bps total). Two relatively strong employment reports and an upside surprise with Q4 GDP data caused some rethinking, but this could be reversed just as easily.

While all these data points matter, we will be watching another release very closely, as well, one that few investors pay attention to and the Fed itself either doesn't care about or is doing a great job pretending it doesn't care about: tomorrow afternoon's report on the growth of the money supply, or lack thereof, the M2 measure of money, in particular.

That measure of money, in spite of QE, did not soar during the Great Recession and Financial Crisis of 2008-09, and therefore did not cause inflation. The main reason is that though the Fed did trillions in QE, through heavy-handed regulation, banks were forced to boost reserves.

But 2020-21 was different. Banks were paid to push the money into the economy (remember PPP loans?) and M2 skyrocketed 40.7%. This led to the surge in inflation that followed in 2021-22. Since then, M2 has actually declined 3.2% in 2022-23, taking the steam out of inflation, but so far hasn't affected economic growth.

But in the last two months of 2023, M2 started growing at a moderate pace again, up at a 4.1% annualized rate. If the Fed keeps it up, not just for one month but as a trend, that would be good news and might even reduce the risk of a recession later this year.

While we watch M2, others have been eyeing the relationship between long and short interest rates. In October 2022, the 3-month Treasury yield rose above the 10-year yield, and has stayed there. This is called an "inverted yield curve" and historically signals that the Fed is tight and a recession is often on the way.

But in an "abundant reserve" monetary policy, higher short-term interest rates no longer signal "tight" reserves. In fact, with reserves so abundant, the Federal Funds Rate is no longer determined in a market, but is actually set at the whim of the Fed. Technically, this is price fixing.

So, the yield curve doesn't mean what it once did. Longer-term bond yields now are hugely affected by what investors think the Fed might do with rates, rather than how those rates reflect underlying economic trends. The Fed has convinced itself and the markets, that it can move rates up and down with the economic data perfectly, but this is hubris. The Fed has held interest rates below inflation roughly 80% of the time since 2009, leading to distortions in markets and the banking system.

Having said that, with short-term rates no longer excessively low, and the money supply down in the past 18 months, we believe the economy is starting to falter.

Retail sales have declined in three of the past four months. Manufacturing production, excluding the auto sector has declined four months in a row. Meanwhile, home building got hammered, with both housing starts (-14.8%) and completions (-8.1%) dropping sharply while new home sales are down 5.3% in the past four months.

We advise watching the path of M2 to tell how much additional faltering it will do in the year ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
2-26 / 9:00 am	New Home Sales – Jan	0.684 Mil	**0.674 Mil**	0.661 Mil	0.664 Mil
2-27 / 7:30 am	Durable Goods – Jan	-5.0%	**-6.7%**		0.0%
7:30 am	Durable Goods (Ex-Trans) – Jan	+0.2%	**+0.1%**		+0.5%
2-28 / 7:30 am	Q4 GDP Second Report	+3.3%	**+3.3%**		+3.3%
7:30 am	Q4 GDP Chain Price Index	+1.5%	**+1.5%**		+1.5%
2-29 / 7:30 am	Initial Claims – Feb 25	210K	**209K**		201K
7:30 am	Personal Income – Jan	+0.4%	**+0.4%**		+0.3%
7:30 am	Personal Spending – Jan	+0.2%	**+0.2%**		+0.7%
8:45 am	Chicago PMI – Feb	48.0	**47.8**		46.0
3-1 / 9:00 am	ISM Index – Feb	49.5	**49.2**		49.1
9:00 am	Construction Spending – Feb	+0.3%	**+0.5%**		+0.9%
afternoon	Total Car/Truck Sales – Feb	15.4 Mil	**15.4 Mil**		15.0 Mil
afternoon	Domestic Car/Truck Sales – Feb	11.9 Mil	**12.0 Mil**		11.6 Mil

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.