First Trust
Monday Morning OUTLOOK

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The Fed: What to Expect and What to Watch

If you're still wondering how much the Federal Reserve will raise short-term interest rates next week, you should wonder no more: the Fed is almost certainly going to raise rates by three-quarters of a percentage point (75 basis points), just like it did back in both June and July. That'll put the target short-term rate at 3.125%, the first time it's been north of 3.0% since early 2008.

Why are we so confident the Fed will raise 75 bps next week? Because Fed Chief Jerome Powell and other policymakers have been sounding hawkish and they haven't pushed back on the futures market's expectations of 75 bps. This Fed doesn't like surprises, so if intended to do 50 bps, it would have pushed back forcefully by now against the expectation of 75 bps.

Beyond this week, we expect smaller, but continued rate hikes, of about 100 basis points total before the Fed is done by early next year. That means getting to around 4.0% on short-term rates. After that, don't expect the Fed to cut rates until it is either very confident inflation is heading down toward its 2.0% target or the economy is heading into recession.

But investors need to focus not only on what the Fed is going to do with interest rates, but also on what's happening with the money supply and bank lending. The world of "abundant reserves" – how the Fed now manages monetary policy, as opposed to the "scarce reserves" system prior to the Financial Panic of 2008 – is an unprecedented, experimental, and potentially volatile world.

The M2 measure of the money supply grew a very rapid 24.8% in 2020 and 12.4% in 2021. Year-to-date through July, M2 has grown at only a 1.8% annual rate in 2022. Since inflation came from this money printing, we see this as progress!

However, bank credit (all securities, loans and leases on banks' books) keeps expanding, having grown 8.6% in 2020, 9.1% in 2021, and 8.6% annualized through August in 2022. We will be watching both sets of figures, M2 and bank credit. If the Fed gets its way, bank credit should slow as the Fed's higher interest payments to banks deter more lending. Remember, in the abundant reserve system, the Fed pays banks interest to do nothing with their reserves! If bank credit keeps expanding rapidly into next year, the Fed may have to keep rates moving significantly higher than 4.0% to shrink the amount of money circulating.

The problem is that the Fed thinks it can manage both real economic growth and inflation just by targeting short-term rates. We think the jury is still out and won't be coming to a verdict anytime soon. Essentially, the Fed is hoping that it can pay banks enough to prevent them from lending, even though Powell says inflation came from the pandemic, not bad monetary policy. That process of tightening is in stark contrast to the old system, where the Fed would directly withdraw liquidity from the banks.

In this precarious environment, we are sticking to our view that the US stock market is "range bound." (See MMO, June 21, 2022). It will not get back into a long-term bull market at least until we know how far the Fed has to go to control inflation and probably not until the next recession has started.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-13 / 7:30 am	CPI – Aug	-0.1%	**0.0%**		0.0%
7:30 am	"Core" CPI – Aug	+0.3%	**+0.5%**		+0.3%
9-14 / 7:30 am	PPI – Aug	-0.1%	**+0.2%**		-0.5%
7:30 am	"Core" PPI – Aug	+0.3%	**+0.2%**		+0.2%
9-15 / 7:30 am	Initial Claims – Sep 10	227K	**228K**		222K
7:30 am	Retail Sales – Aug	0.0%	**-0.2%**		0.0%
7:30 am	Retail Sales Ex-Auto – Aug	0.0%	**-0.4%**		+0.4%
7:30 am	Import Prices – Aug	-1.2%	**-0.8%**		-1.4%
7:30 am	Export Prices – Aug	-1.1%	**-0.5%**		-3.3%
7:30 am	Philly Fed Survey – Sep	2.5	**6.4**		6.2
8:15 am	Industrial Production – Aug	+0.1%	**+0.1%**		+0.6%
8:15 am	Capacity Utilization – Aug	80.3%	**80.3%**		80.3%
9:00 am	Business Inventories – Jul	+0.6%	**+0.6%**		+1.4%
9-16 / 9:00 am	U. Mich Consumer Sentiment- Sep	60.0	**59.1**		58.2