The Wrong-Way Fed Policy

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Econoclast Comment on Wrong-headed Fed Policy

Monetary policy has been going the wrong way on a one-way highway.

- Fed officials decided to: 1) Engage in quantitative tightening (QT) and 2) Jack-up short-term interest rates at the same time.
- From the start it was clear that a dual tightening policy would eventually create major damage to the financial markets and the real economy.
- Reasons why this dual Fed tightening policy made no sense have been discussed in each issue of Econoclast Trends since June.
- QT, from the get-go, has been aimed directly at bringing down the equity market while short-term interest rates take direct aim at slowing the real economy and indirectly at pushing the equity market lower through the various higher interest-rate channels.
- The U.S. economy reflects healthy economic growth due to: 1) Trump tax reform and 2) a lighter regulatory burden. Inflation, according to the Fed's inflation measure is 2.2% (y/y) which is close to their target of 2%. The core CPI is also running at 2.2%.
- Given that background, the Fed didn't need to reduce their balance sheet by $50 billion/month starting this month. That is $600 billion/year, which is a massive amount of QT.
- QT deflates highly liquid markets like equities. Neither Fed officials nor anyone else has had experience with the time lags associated with QT. QT started one-year ago with $10 billion/month. The $10 billion/month reduction was not an issue.
- But the $50 billion/month is, because equities are discounting that $600 billion reduction over the next 12 months. Fed officials need to stop or dramatically slow QT or they will crash both equities and this economy.
- Fundamentals of strong dividend growth, earnings growth, profit margins, moderate inflation and a strong dollar support higher equity prices. Will the Fed allow those higher prices?

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