First Trust
Monday Morning OUTLOOK
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A Whiff of Volcker

Investors expected something dramatic from the Fed last week. Instead, they caught a little whiff of Paul Volcker.

The most aggressive move would have been cutting or eliminating the interest rate the Fed pays banks on reserves. Next would have been Quantitative Easing III (QE3). Finally, and the least impactful of them all, was Operation Twist.

QE1 and QE2 have created $1.6 trillion in excess reserves. Banks have chosen to hold these at the Fed rather than lend them out. In part, this is because the programs are perceived as temporary, so when the Fed reverses quantitative easing, banks would need to shrink their balance sheets and call in loans. This would not be good for business.

Since mid-2008, the Fed has boosted the monetary base by 207%, but M2 has grown just 20%. It is M2 that drives inflation, so the 125% rise in gold prices since mid-2008 has priced in about one-half of QE turning into M2.

If the Fed were to cut the 0.25% interest rate it pays on reserves (some even call on the Fed to charge banks a fee for holding them!), banks might shrink their reserves and expand the money supply. If so, nominal GDP and inflation would accelerate.

But the Fed did not make this move. Instead, it announced "Operation Twist." The Fed will sell $400 billion of shorter term Treasury bonds and buy $400 billion of longer term bonds by mid-2012. This will supposedly bring down long-dated Treasury yields. It may, temporarily, but the most important news was the Fed did no further easing of monetary policy.

The result – gold is down 14% from its peak. At the same time, the stock market has declined. Equity prices have fallen because many think that without new Fed action there is nothing to support stocks. These investors believe QE raised stock prices. But price-earnings ratios have fallen in the past two years, not risen. If Fed liquidity were the cause of rising stock prices, P-E ratios should have gone up, not down.

Meanwhile, the Fed chose to badmouth the economy as a justification for Operation Twist. It said there were "significant downside risks." But the Fed looks at the same data we all do and the most high-frequency data, like unemployment claims and chain store sales still say we are not in recession. Moreover, Edmunds and JD Power are both forecasting that auto sales rose in September.

Don't get us wrong. We are not arguing in favor of a more aggressive Fed. We think that a 0% federal funds rate is already too low and the Fed is already overly loose. Consumer prices are up 3.8% versus a year ago while "core" consumer prices, which exclude food and energy, are up at a 2.7% annual rate in the past six months. Nominal economic growth, which includes inflation, suggests Fed policy is accommodative. The end of QE2 does not change any of this. The Fed is still very easy.

We believe equities will soon shrug off last week's news. The economy is not in a recession and while European problems are a real issue, US banks have plenty of capital to sustain the system in case of further crisis.

Despite all the dour language and the volatile market reaction, we like the downward move in gold. What it says is that the Fed will no longer follow a path of policy that seemed to print money with no regard for any historical lessons. As Paul Volcker showed us, tighter money can be in a country's best interest. Gold investors should look out below. But, for equities, this is a good sign.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-26 / 9:00 am	New Home Sales - Aug	0.293 Mil	**0.297 Mil**	0.295 Mil	0.298 Mil
9-27 / 9:00 am	Consumer Confidence - Sep	46.0	**45.9**		44.5
9-28 / 7:30 am	Durable Goods - Aug	-0.2%	**+2.0%**		+4.1%
7:30 am	Durable Goods (Ex-Trans) - Aug	-0.2%	**+0.1%**		+0.8%
9-29 / 7:30 am	Q2 GDP First Report	+1.2%	**+1.3%**		+1.0%
7:30 am	Q2 GDP Chain Price Index	+2.4%	**+2.4%**		+2.4%
7:30 am	Initial Claims - Sep 24	420K	**420K**		423K
9-30 / 7:30 am	Personal Income - Aug	+0.1%	**+0.3%**		+0.3%
7:30 am	Personal Spending - Aug	+0.2%	**+0.2%**		+0.8%
8:45 am	Chicago PMI - Sep	55.0	**56.9**		56.5
8:55 am	U. Mich. Consumer Sentiment	57.8	**58.0**		57.8