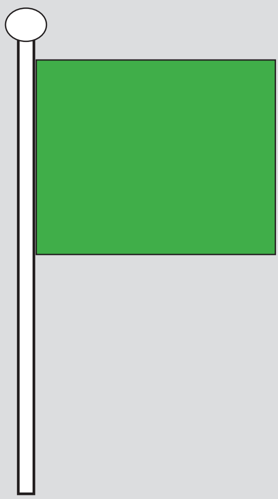
Financial Research Publishing, Inc.

Money Forecast Letter



True wisdom comes from understanding that money matters.

April 2022

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April 2022

Ashland, Massachusetts - April 8, 2022

There are two topics I wish to cover this month. In reality, it is one topic, but I fear any attempt to weave the two halves together before giving the proper background for each might prove overwhelming, not necessarily to you but to me.

I want to address some really "big picture" stuff this month, and, try as I might, I couldn't come up with a way to present both in a single narrative without running the risk of making a hash of it. I thought it made more sense to present the facts for each of the two parts. Then give you my opinion on how, when you combine the two, you better understand the challenges the Federal Reserve faces in fulfilling its dual mandate to promote growth while keeping inflation at a reasonable level.

Part one is straightforward. While we tend to lose sight of the primary reason why the Federal Reserve exists, it never really changes. The art of sound monetary policy is the practice of managing the nation's money supply. Adrian Van Eck had a simple response to those who denied this fact; he asked the skeptics to imagine the state of the

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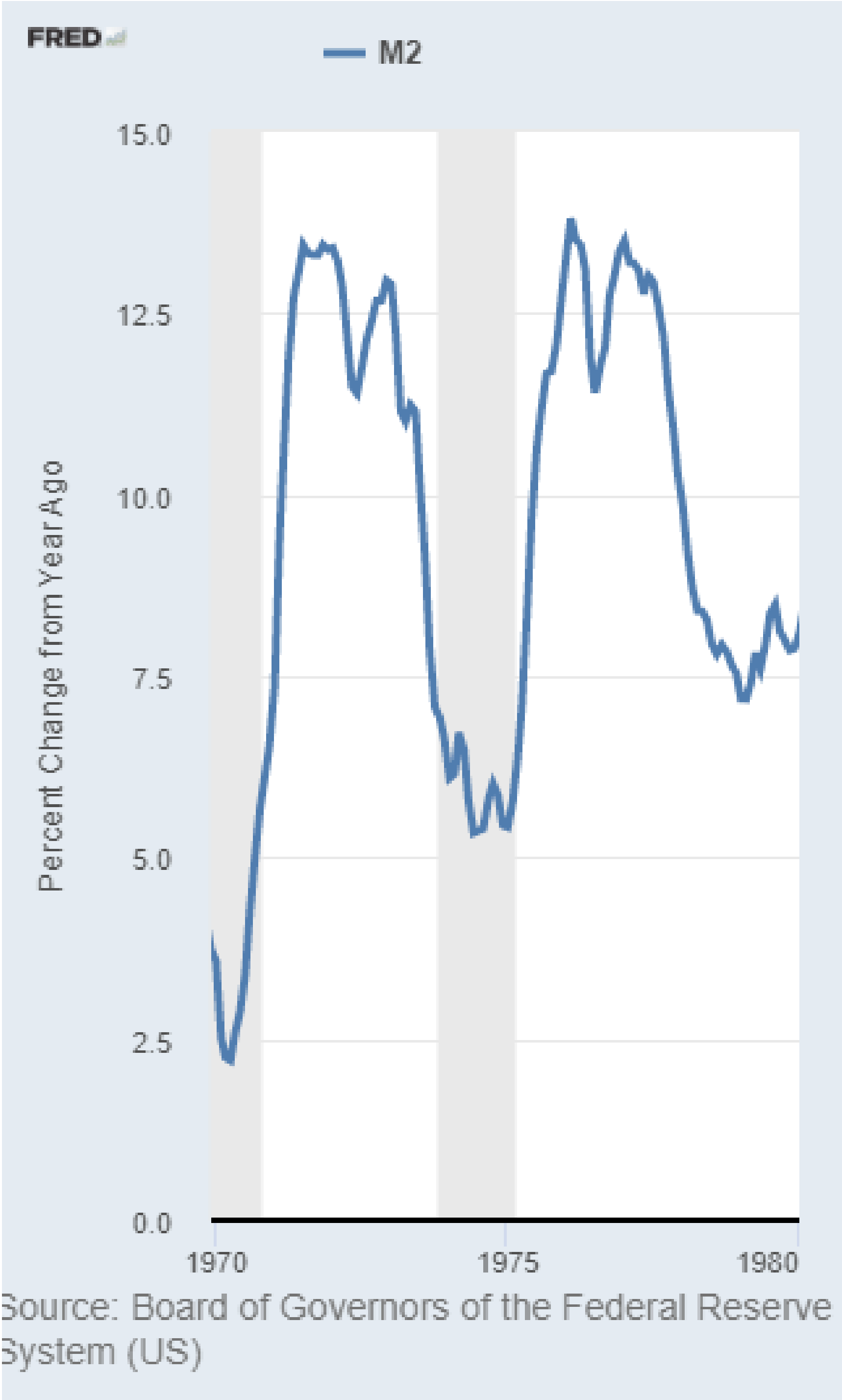

FRED
M2
15.0
12.5
10.0
7.5
5.0
2.5
0.0
Percent Change from Year Ago
1970
1975
1980
Source: Board of Governors of the Federal Reserve System (US)

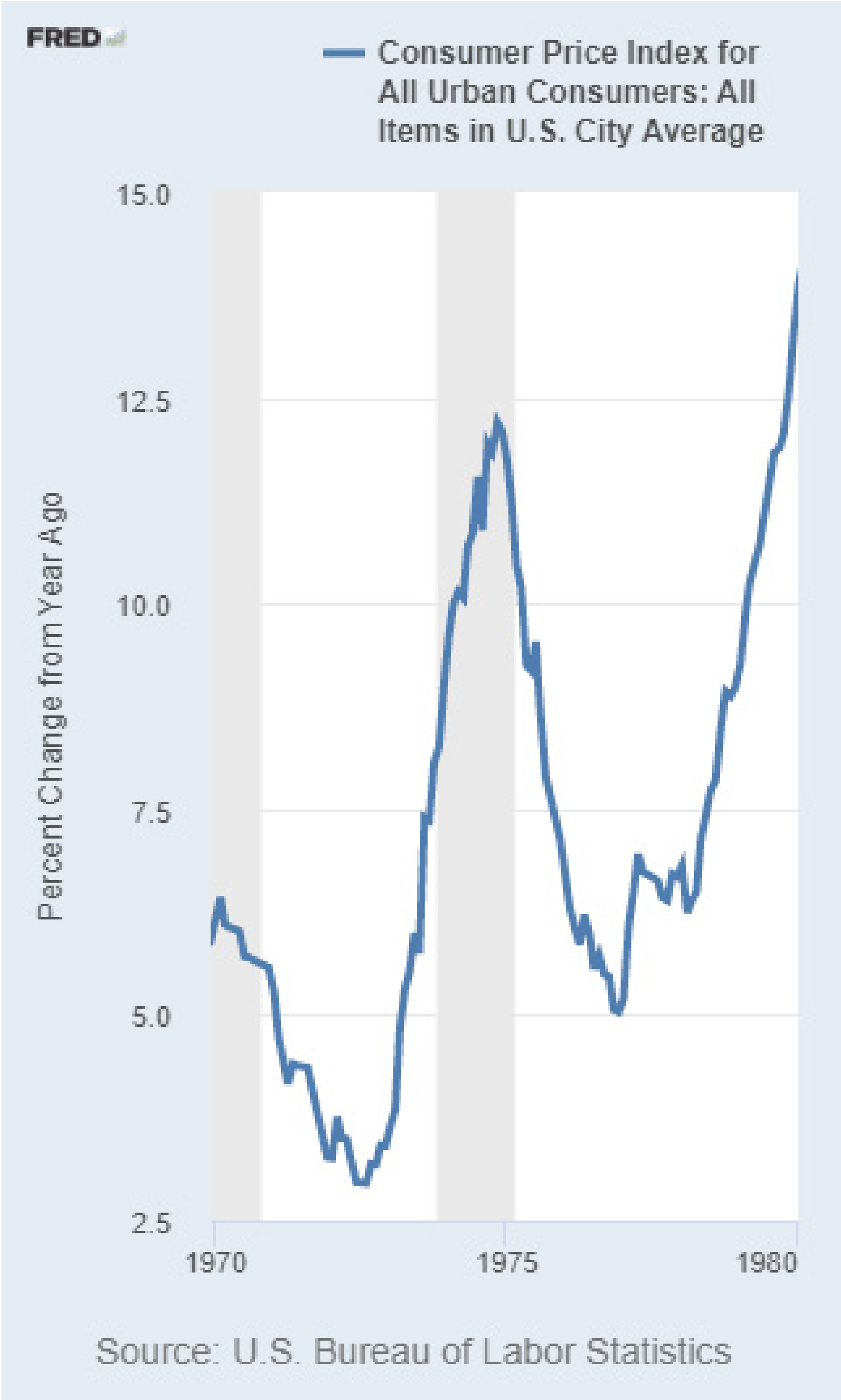
economy if the money supply was zero.

There is never any chance of that happening, but it is easy to imagine the results. Without money, there would be no way to assign value to products; commerce would slow to a crawl as all economic activity would depend on a barter system. There would be no such thing as credit, and the idea of economic growth would be a pipedream.

Now imagine what the economy would look like if there were an unlimited money supply. Imagine everyone having a "magic" checkbook, where every check would be honored by the bank. In effect, every person would be their own Federal Reserve Bank. These days, only the Fed has the legal authority to create money out of thin air simply by writing a check. If you think homes are expensive right now, imagine what would happen if everyone could afford to pay any amount demanded by the seller. After all, you have a magic checkbook; no matter the asking price, you can afford it.

These two ridiculous extremes give us a proper understanding of the critical role the supply of money plays in our economy.

The biggest problem with the Fed today is that it has mentally disconnected the money supply from monetary policy. Before you get too upset at Jay Powell, I ask you to keep in mind that this statement about the Fed has been true for most of its one hundred and nine-year history.

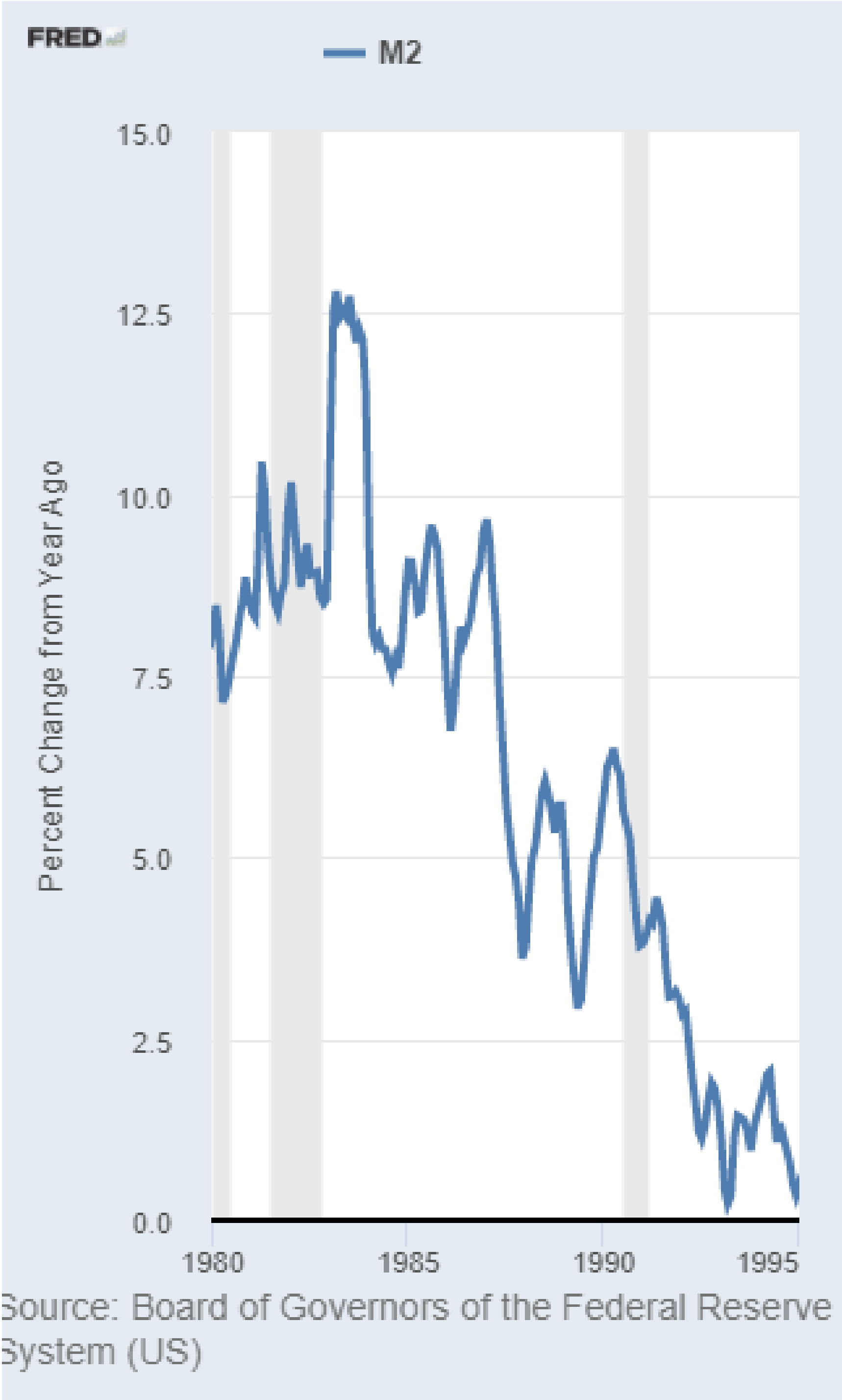

FRED
Consumer Price Index for All Urban Consumers: All Items in U.S. City Average
15.0
12.5
10.0
7.5
5.0
2.5
Percent Change from Year Ago
1970
1975
1980
Source: U.S. Bureau of Labor Statistics

While the leaders of today's Fed have been especially bad at understanding the central importance of controlling the nation's money supply, its mistakes are only a matter of degree. Until disaster strikes, the Fed often ignores the dangers of providing too much or too little money for the economy.

From early on, the Fed has ignored the amount of money it creates and focused instead on something they thought was more important. I am guessing you already know that I am referring to interest rates. Mistakes regarding the money supply are at the root of every misstep the Federal Reserve has made since its creation back in 1913.

Because I have limited space in this letter, I will confine myself to examining monetary policy during the past fifty years.

It is surprisingly easy to grasp this history if you look at it as three separate eras. The first era covers the years 1970 thru 1979. This decade was a particularly ugly time for American monetary policy. After decades of prudent money management, the late 1960s introduced the dangerous idea that money no longer mattered. Societal ills needed fixing, and the politicians in charge concluded the Fed was standing in their way. Suddenly, the economists insisting there was no correlation between money supply and inflation became very popular in Washington, DC. Using this highly questionable theory as their cover, the Fed was suddenly knee-deep in officials anxious to print

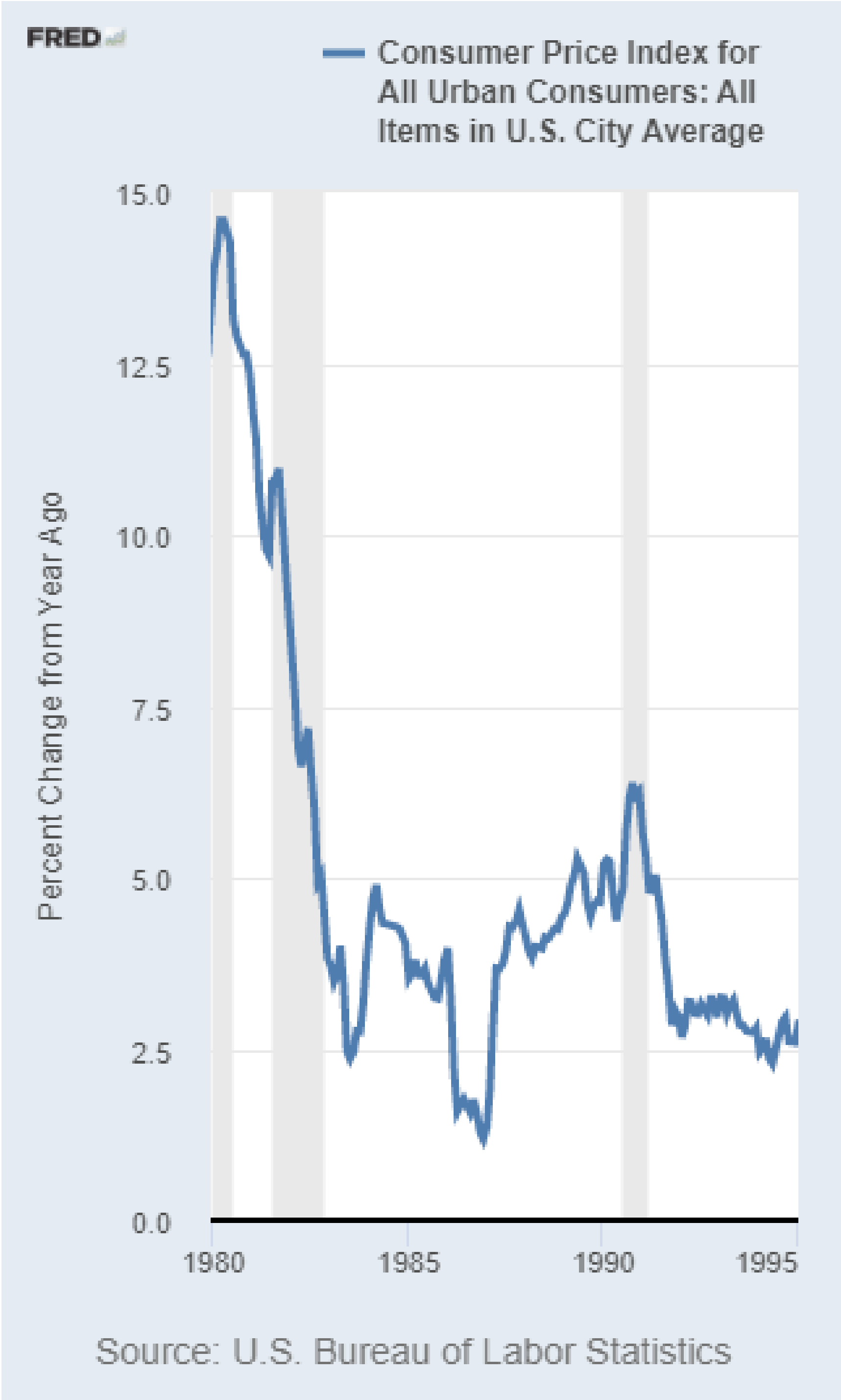

FRED
M2
Percent Change from Year Ago
15.0
12.5
10.0
7.5
5.0
2.5
0.0
1980
1985
1990
1995
Source: Board of Governors of the Federal Reserve System (US)

the money needed to finance ambitious social spending programs.

Standing in their way was President Richard Nixon. When he took office in 1969, the economy was doing pretty well. However, inflation was also growing. Determined to rein in the "credit-card Congress," he announced he would slow inflation by impounding some of the money Congress included in their annual budgets. However, in 1970, when Penn Central, the nation's sixth-largest company, filed for bankruptcy, he panicked. He pushed for more stimulus to reverse the trend of declining growth. It worked; although the US economy did suffer through a recession, it was a shallow one.

Unfortunately, Mr. Nixon's conversion to Keynesianism opened the flood gates. As you can see from the chart on page two, those insisting on the rapid expansion of the money supply carried the day. The annual growth rate of the money supply immediately climbed above 5% and eventually topped 13%. Even when the Fed would "tighten" money, the annual growth rate never fell below 5%.

Of course, this money printing had some predictable side effects. The chart on page four shows you just how wrong the economists were about inflation. The yearly rate took off. Those in denial found many reasons to dismiss the obvious correlation between the rapidly growing money supply and rapidly rising prices. First, they blamed OPEC, and then they blamed "greedy" American corporations.


FRED
Consumer Price Index for All Urban Consumers: All Items in U.S. City Average
Percent Change from Year Ago
15.0
12.5
10.0
7.5
5.0
2.5
0.0
1980
1985
1990
1995
Source: U.S. Bureau of Labor Statistics

Eventually, they revised their economic theories to explain that there could be no growth without inflation.

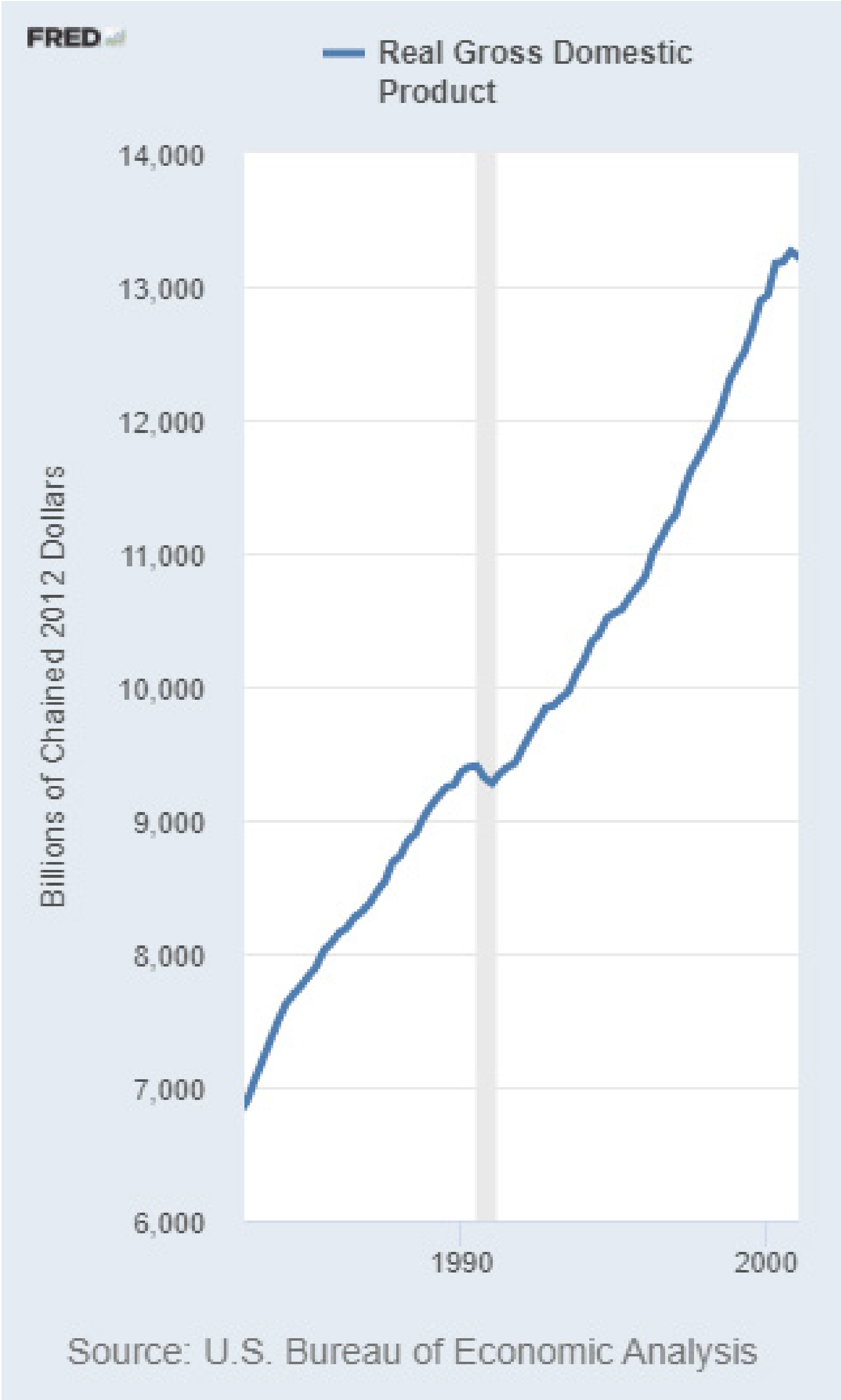
When the renewed push to print even more money produced rapidly rising prices during the late 1970s, the country finally demanded changes.

Enter Paul Volcker and our second era of recent monetary policy.

One man in Washington was paying close attention and taking notes. Paul Volcker was the Under Secretary of Treasury during this tumultuous period. The lessons learned in 1970 served him well when he was appointed as Chairman of the Fed in 1979 and tasked with curbing runaway inflation.

Mr. Volcker soon announced he would end the practice of targeting interest rates and concentrate instead on the long-term control of the nation's money supply. He knew it would be economic suicide for the country to quit inflation cold turkey, so he intentionally took his time. When the initial shock of the policy change pushed the country into recession, Mr. Volker backed off and gave the country time to regain its balance. In 1981, he tightened the screws again. He knew it would cause another recession, but he took care not to let it become something worse.

As you can see from the chart on page six, the job of reining in the runaway growth of the US money supply went on for years. It continued even after Alan Greenspan replaced

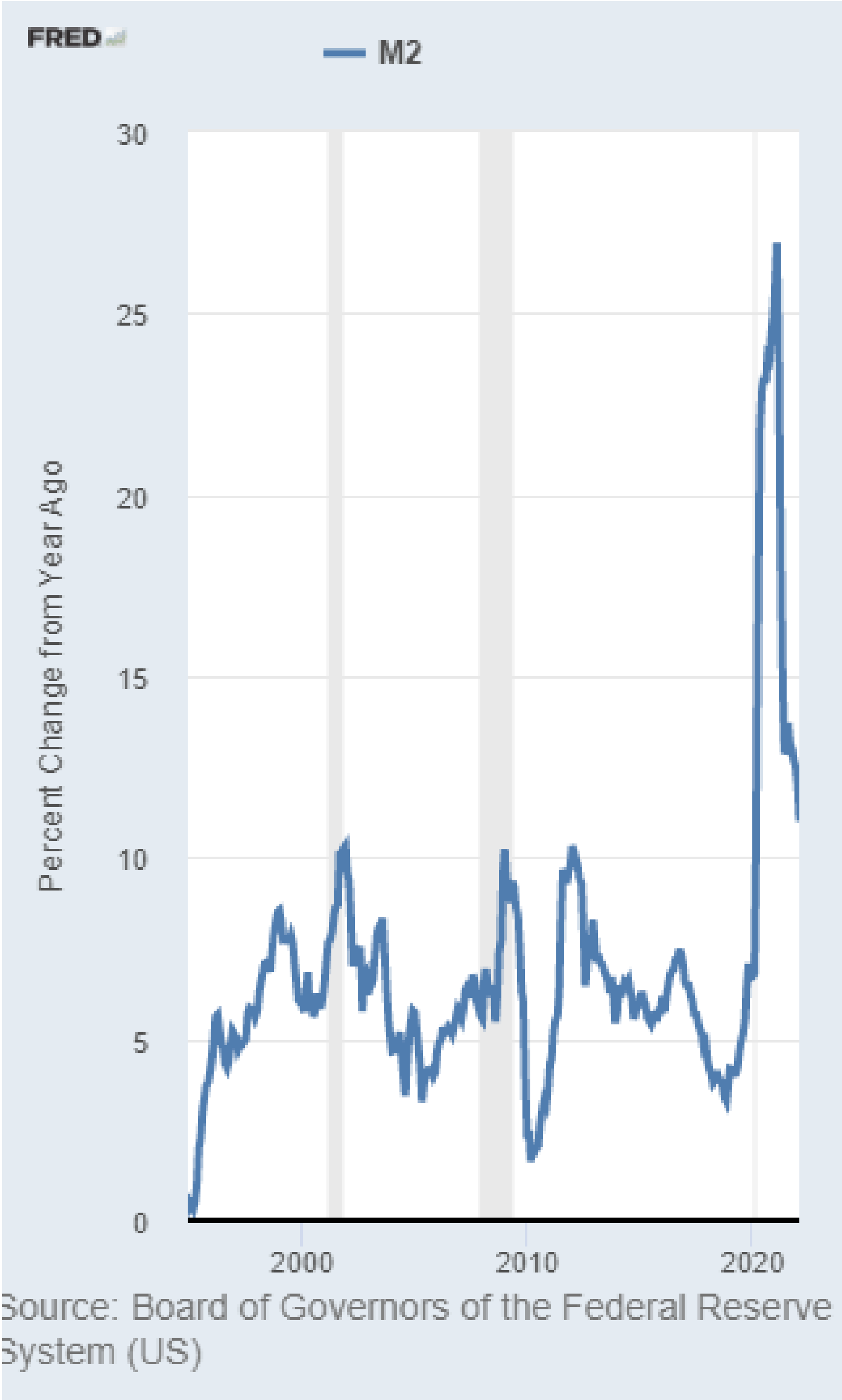

FRED
Real Gross Domestic Product
14,000
13,000
12,000
11,000
10,000
9,000
8,000
7,000
6,000
Billions of Chained 2012 Dollars
1990
2000
Source: U.S. Bureau of Economic Analysis

Paul Volker in 1987. In the early 1990s, the annual growth rate for the money supply dipped below 2.5%. As both Chairman Volcker and Chairman Greenspan expected, their actions ended the nation's inflation problem. The chart on page eight shows the clear correlation between declining money supply growth and lower inflation rates. By the early 1990s, America believed inflation was gone for good.

Most important, the go-slow approach to ending inflation allowed the economy to avoid another severe recession. As you see on page ten, the nation experienced just one official recession between 1983 and 2000, and we can lay at least some of the blame for that one on the sudden outbreak of the Persian Gulf War, which caused oil prices to nearly triple in just four months.

With inflation tamed, the Fed quietly shifted gears, and America entered a new era in monetary policy.

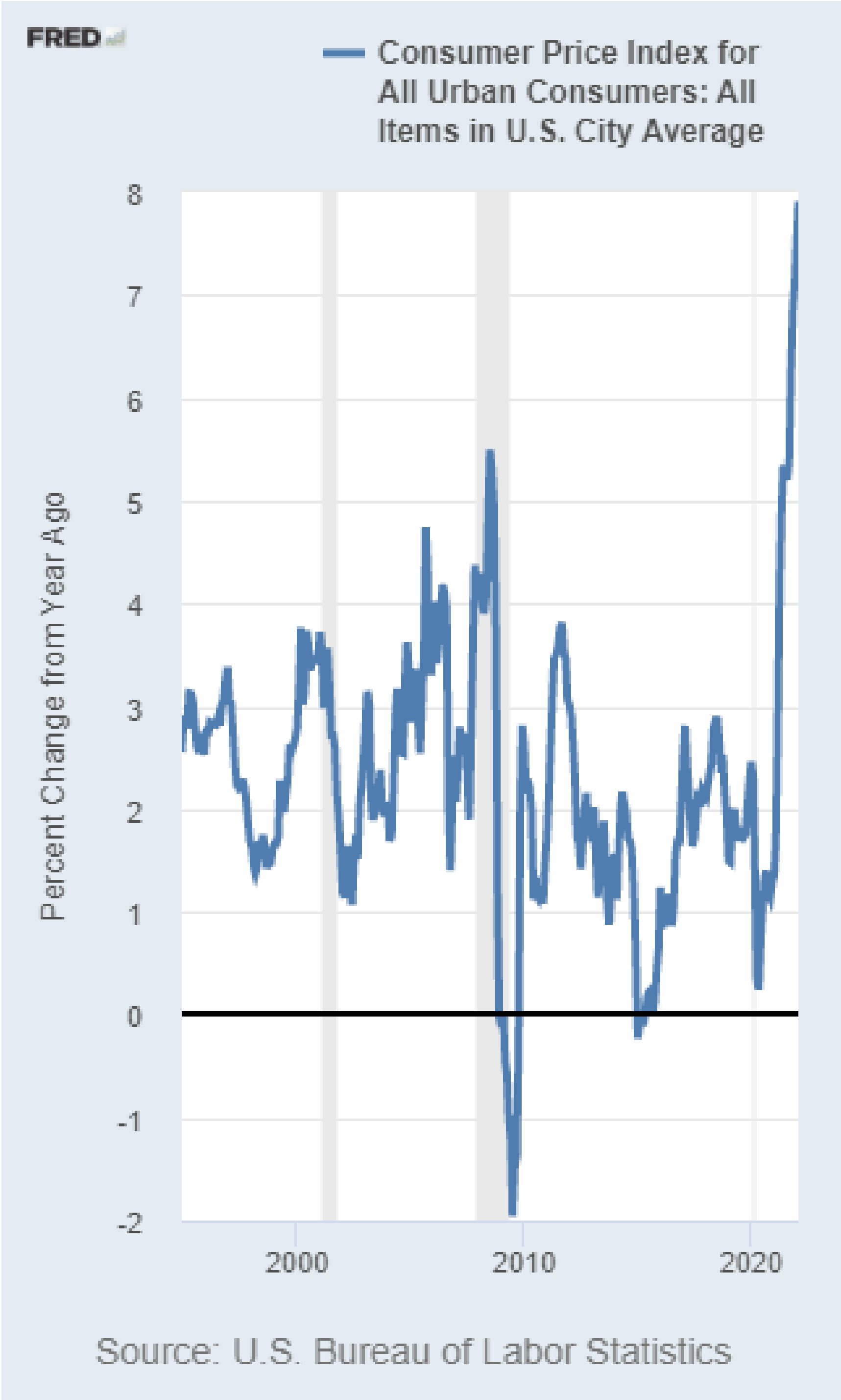
Despite its success at controlling inflation and promoting growth by managing the nation's money supply, the Fed found itself pressured to loosen up as the 1990s rolled on. After famously warning the country about "irrational exuberance" in 1996, Alan Greenspan quietly abandoned the Fed's efforts to concentrate on the money supply and returned to an interest rate-based approach to monetary policy. Not surprisingly, the switch produced very different results.


FRED
M2
30
25
20
15
10
5
0
Percent Change from Year Ago
2000
2010
2020
Source: Board of Governors of the Federal Reserve System (US)

As the chart on page twelve makes clear, the change in focus produced a jump in money creation. M2 money supply growth rose to 5% in 1996 and eventually touched 12.5% by September 2001. It didn't take long for the inevitable results of loose money to kick in. As you see on page fourteen, once the country shook off the ill effects of the Dotcom bust, the annual inflation rate started to climb. Helped by the rising price of homes during the housing bubble, inflation rose to 2%, 3%, and then 4%. Before the bottom fell out of the economy, the annual inflation rate surpassed 5%.

We tend to forget this not so ancient history because the Fed rewrote all the monetary policy rules in the wake of the Financial Panic of 2008. When the Fed fully committed to keeping both short and long-term interest rates at historic lows, most people predicted that epic inflation would soon follow. For its part, the Fed hoped its critics were right. They believed with all their heart that inflation was too low. As you can see from the chart on page fourteen (and as you know already), this inflation never materialized.

After a decade of epically low rates, the nation's money supply did not grow uncontrollably from 2013 to 2019. In fact, the growth rate decelerated. Despite their best efforts, the Fed could not boost the money supply, it could not boost growth, and it could not increase inflation. If you have been reading this letter for a while, you already know what I think kept inflation at bay. Despite trillions of dollars spent on buying bonds to drive rates down, the Fed never found a way to force all those freshly created bank


FRED
Consumer Price Index for All Urban Consumers: All Items in U.S. City Average
Percent Change from Year Ago
8
7
6
5
4
3
2
1
0
-1
-2
2000
2010
2020
Source: U.S. Bureau of Labor Statistics

reserves (see page sixteen) into the real economy.

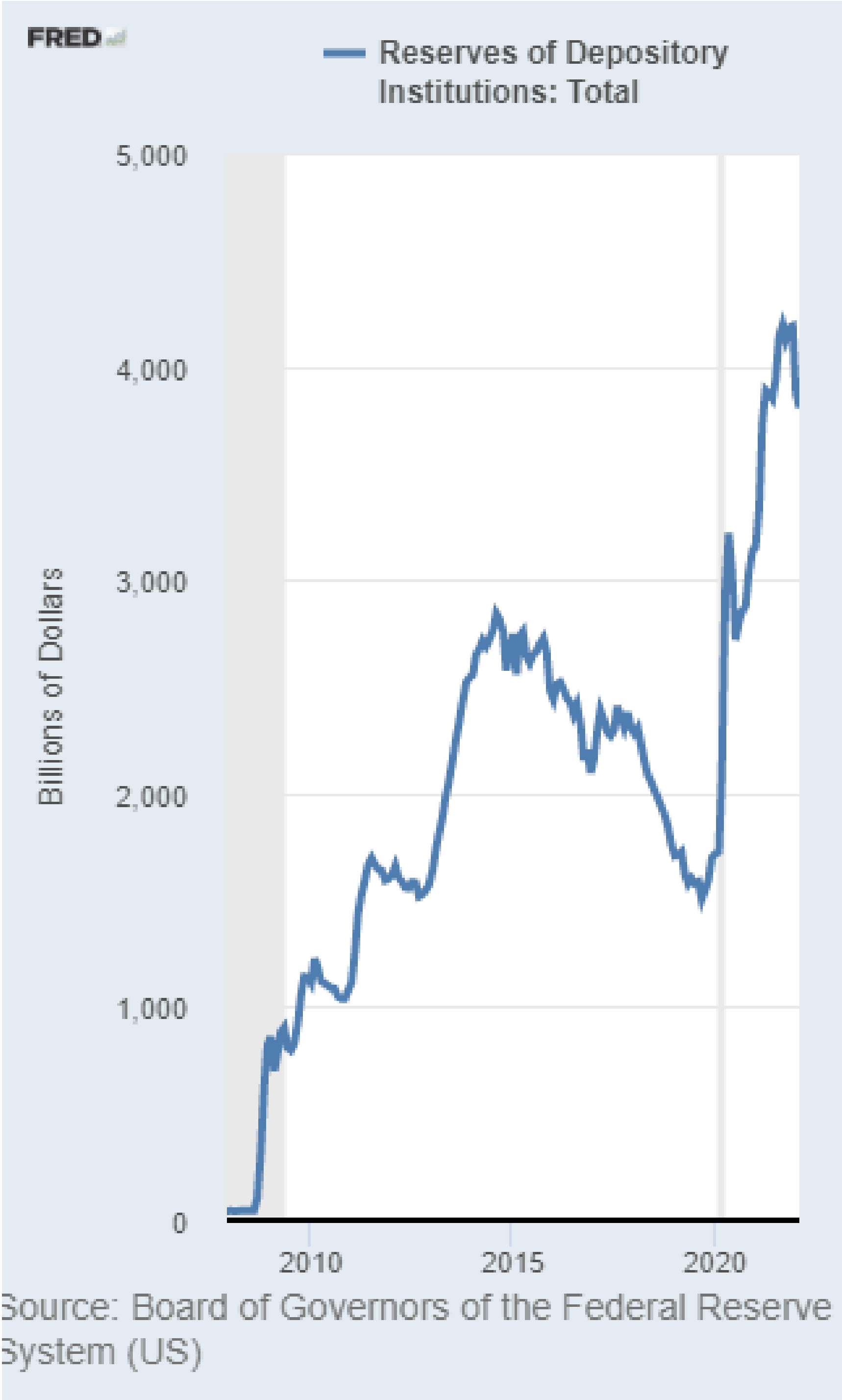
The Fed forgot about the indisputable link between the money supply and economic growth and inflation. They wouldn't have embarked on their ill-fated quantitative easing plan if they hadn't.

It is tempting to argue that the country began the fourth era in recent monetary policy in March 2020, when the Fed moved to drive rates back down towards zero to cushion the blow of the government-mandated shutdown of the US economy. While I agree their efforts were unprecedented when measured by the speed in which they acted, the Fed's efforts to drive rates down were, in the end, just a larger-scale version of what it had been doing since the late 1990s. What confuses people is the sudden reappearance of inflation.

You can be forgiven for assuming the Fed's rush to drive rates to zero is the cause of this new wave of higher prices, but I wish to consider other factors that might better help us explain why inflation is suddenly such a problem.

At the start of this letter, I mentioned that I had two topics I wanted to cover. Consider this the official beginning of topic two.

Why, after four decades, are we suddenly plagued by higher prices? I hoped a review of the last fifty years of Fed policies would provide a foundation for this discussion.


FRED
Reserves of Depository Institutions: Total
Billions of Dollars
5,000
4,000
3,000
2,000
1,000
0
2010
2015
2020
Source: Board of Governors of the Federal Reserve System (US)

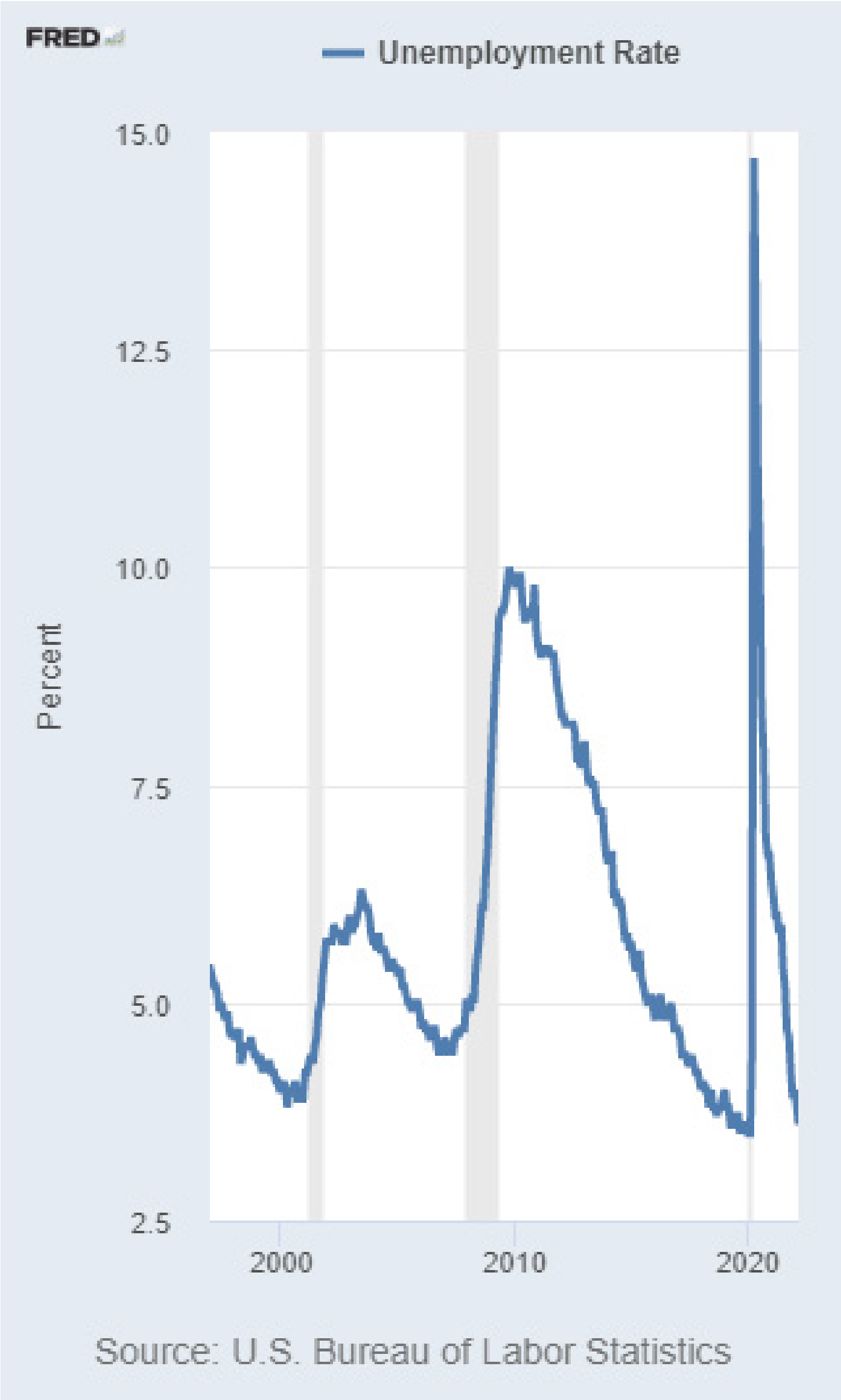
I wanted to reinforce the idea that the money supply, not interest rates, determines how much or how little inflation we get.

Here is a simple fact, the nation has experienced low interest rates for fifteen years, yet the Fed has failed to produce more inflation. They thought they would get it if they drove the unemployment rate below its "natural rate.' As you can see from the chart on page eighteen, it turns out low unemployment doesn't cause inflation after all. Since 2008, when the Fed first embarked on its plan to buy long-term bonds to drive interest rates lower, the Fed consistently told us that they would "normalize" rates once the unemployment rate fell low enough to put upward pressure on prices. They (wrongly, as it turns out) believed that low unemployment would produce higher wages, which would allow consumers to expand consumption and drive prices higher.

They are not alone in this misconception. Nearly everyone on Wall Street believes that higher wages are inflationary. And they have wasted little time blaming this current bout of inflation on the dramatic rise in America's take-home pay.

But there's a problem here too.

On page twenty, you see the chart tracking disposable personal income over the past few years. Notice how pre-pandemic incomes grew steadily at around 5%. Notice too how, just before the pandemic, income growth slowed


FRED
Unemployment Rate
15.0
12.5
10.0
7.5
5.0
2.5
Percent
2000
2010
2020
Source: U.S. Bureau of Labor Statistics

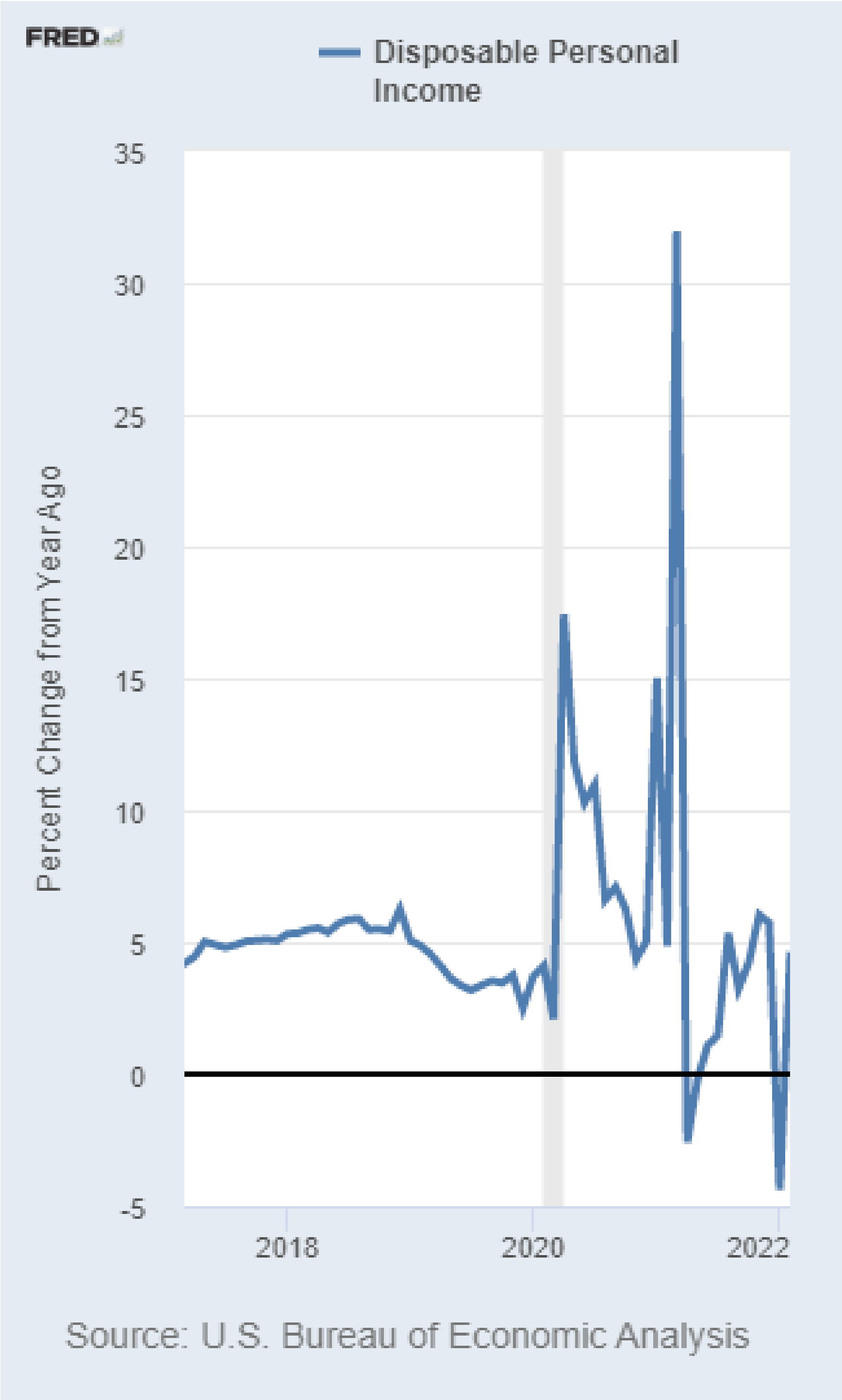
slightly. Of course, the chart turned into a rollercoaster once the pandemic began. Thanks to generous government assistance, incomes actually increased by 18%, while the nation's unemployment rate climbed from 3.5% to 15%. The second wave of government help produced another spike in incomes, which disappeared just as quickly as the first once the checks stopped going out.

Over the past year, personal income growth has been far more subdued. If we take all the statistical noise out of the chart, we can say that recent income growth has returned to pre-pandemic levels. In short, there is nothing here that makes a case for consumer-driven inflation during the last year and most definitely not for the year to come.

This data is not hard to find. It is available to anyone who wants to spend a few minutes trawling the St. Louis Fed's data website. If I can pull it up, it is a sure bet the Federal Reserve Open Market Committee knows how to get its hands on it.

Finally, we have the most damning information regarding the prospects for continued high inflation rates in the coming year. I ask you to go back and look at the M2 chart on page twelve. Specifically, I want you to note what has happened to money growth during the past year. In March 2021, the best measure of the nation's money supply was growing at an annual rate of 27%. Today, that rate has declined to 10.7%.

You would think this might give hope to those worried about


FRED
Disposable Personal Income
Percent Change from Year Ago
35
30
25
20
15
10
5
0
-5
2018
2020
2022
Source: U.S. Bureau of Economic Analysis

inflation. Yet, all I hear are pundits who insist Americans should prepare themselves for the return of stagflation (the dreaded combination of low growth and high inflation.) This argument doesn't make sense. If the Fed is on its way to killing growth, why wouldn't that suggest a lessening of inflationary pressures? After all, in their minds, wage growth equals inflation. How can we keep inflation alive if unemployment rises and incomes fall?

Understanding the inherent paradox of this argument should help you feel better about what is likely to happen during the rest of this year and 2023.

Embrace the idea that money matters. Understanding this makes it much easier to anticipate what comes next for the American economy. Remember that the recent decline in M2 growth from 27% to 10.7% means the nation's money supply is growing by 10.7% a year. That is not a number often associated with a pending recession.

Secondly, keep in mind that rising interest rates are not a death knell for the economy. After many years of ultra-low rates, Americans have forgotten what "normal" means. The current interest rate on a 30-year mortgage has climbed from 3.0% to 4.75 % over the past five months. For many, this is a reason to sow panic among homebuyers. But consider this, the 30-year mortgage rate stood at 5% in November 2018, and the world didn't end. Before the Fed decided to take over the bond market in 2008, a 6%

30-year mortgage rate was standard.

Lastly, remember that government checks are not the only form of support holding up this economy. Remarkably few people know that the federal government and many state governments continue to enable renters to skip their monthly payments and college grads to delay their student loan obligations. The average monthly student loan works out to about $325 a month. That's the equivalent of giving each debtor 5,000 pretax dollars a year to spend as they please. The Biden administration has just extended the student loan moratorium until September. Is there anyone who believes they won't push for another delay with the November election looming?

Stop worrying about the Fed and its plans to raise interest rates. The rate on the 10-year US Treasury is so low that it could rise 3% and still only get back to the lower end of what used to be considered normal. While we would all be better off if the Fed lets rates get back to historical levels sooner rather than later, history suggests that slow but sure will win the race. A half-point increase of the fed funds rate at the next meeting might be a sobering warning to those pushing inflation forever fantasies, but if it takes two years to manufacture a return to normal, I would be willing to live with that. What we need is a Fed that is committed to this timetable. I'm still unsure if the current Fed Chairman is onboard with the plan.

— David C. Jennett

David C. Jennett's

Investment Letter

The green flag is back on the cover of the Money Forecast Letter!

Despite the best efforts of the media to scare you, there is no reason for investors to panic over the recent headlines regarding the Fed. In our Investment Letter, readers find timely information and insights about their investments, free from the bias and hysteria found in most mainstream media coverage of the markets. If you are not already one of our readers who subscribes to both letters, now might be an excellent time to consider a subscription.

While most of Wall Street sounded alarm bells over rising inflation numbers, Editor David C. Jennett told his readers to remain calm – and stay invested in the stock market. This advice paid off handsomely when the S&P 500 Index climbed 27% in 2020. In his last letter, he told his readers that 2022 will be very different from last year, but not the way Wall Street expects.

Because the stakes are so high, he wants to share this recent letter with you. If you enter a one-year subscription today, he will send it as a bonus. Starting with his following letter, you will get twelve more issues dedicated to making you a better informed and more successful investor.

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