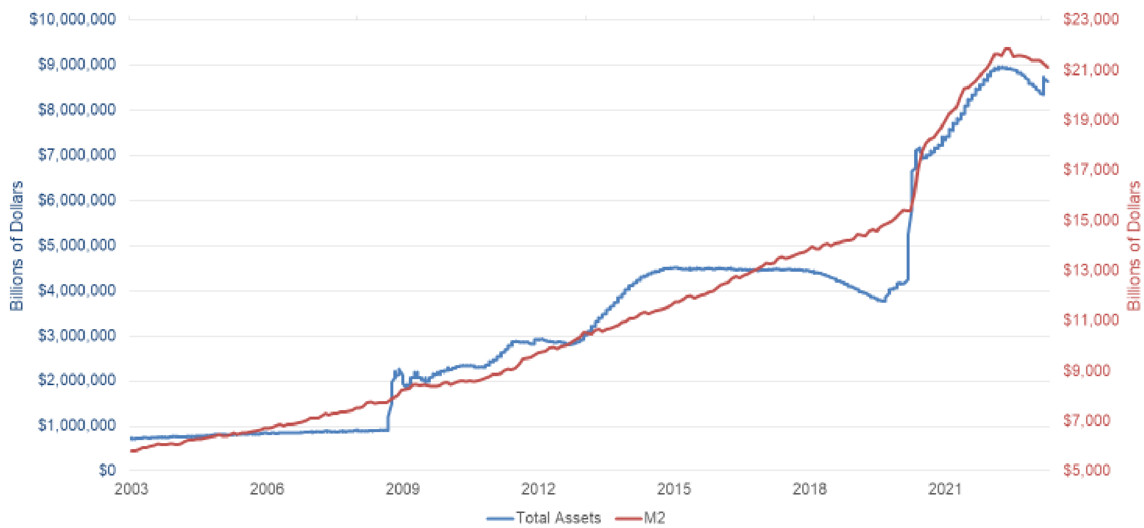
Harry's Take

April 11, 2023

Something New Is Happening: Fed Balance Sheet and M2 Are Falling Together!

Ever since we entered the greatest boom in history with the Baby Boom Spending Wave in the early 1980s, one thing has always risen: the broader money supply, M2. That's the red line in the chart below. People earn more and spend more, and bank deposits obviously grow and benefit as a result. When banks have more deposits, they can lend out more money to leverage normal gains in income, especially to allow people to buy more and larger homes. On top of that, inflation has been falling (as my Inflation Indicator has always forecast well ahead of time), and that allows people to borrow cheaper and to buy better homes, cars, etc., beyond their level of income.

Fed Balance Sheet and M2 Broad Money Supply Fall Together for First Time



Source: Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WALCL, April 9, 2023. Board of Governors of the Federal Reserve System (US), M2 [M2NS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/M2NS, April 9, 2023.

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The reason that the Fed buys bonds with printed money is to inject money into financial assets and to stimulate the economy through the wealth effect. But the chart says that something different is happening in the early stages of the financial crisis that is clearly brewing, as a result of the Fed aggressively raising short-term rates since March 2022. The Fed is likely to do so at least one more time (by 25 bps) into May before pausing… But now, the central bank balance sheet and the broad money-supply indicator M2 are falling together. The stimulus was supposed to help the economy grow, not contract. What's wrong here, given that we're not in a recession yet?

First, note past divergences between the Fed balance sheet and M2:

1) In early 2009, the balance sheet went down a bit, but M2 merely moved sideways.
2) In late 2011 to 2012 the balance sheet was down a bit, but M2 kept rising.
3) From late 2014 through early 2018, the balance sheet basically remained flat while M2 kept rising.

4) Finally, into the COVID pandemic and early 2020, the balance sheet went down significantly for the first time (because there was less stimulus from net bond buying and injecting of money), but M2 still kept going up.

But something new has been happening since March 2022, when this tightening cycle started. The balance sheet has fallen significantly, but this time, M2 has followed. The effects of stimulation appear to have been offset. That has compounded the usual process of banks losing deposits when the economy slows, and this will slow lending even more than would naturally happen in a downturn.

In a downturn, falling interest rates eventually help to cushion the economy, as interest expenses and the cost of borrowing go down for those who are still creditworthy and falling rates raise the value of the banks' long-term Treasury holdings for reserves (because risk-free rates fall while risk-prone rates rise from default risk). But if, during a slowdown, deposits disappear from banks faster than usual, it can compound the downturn rather than cushioning it, as banks are forced to lend less, even to more credit-worthy businesses and households. That's what seems to be different this time, and it could be disastrous, given the unprecedented level of debt and zombie companies all ripe to explode!

I'll have more on this in the May *HS Dent Forecast* newsletter ahead… But my simple interpretation here is that this is another sign that the over-stimulus in reaction to COVID now is backfiring, which will cause a long-overdue recession and debt deleveraging **that will be even worse than the recession of 2008-2009, the worst since the Great Depression.**

Since the Great Boom started in 1983, we have had the longest time ever between recessions—and remember that it is recessions that allow the economy to detox from bad debts and rid itself of zombie companies to restore long-term economic health and growth potential. This downturn should be the worst of our lifetimes and will impact aging Boomers the most. **Baby Boomers will see their retirement nest eggs quickly devalued if they**

are not in more-defensive portfolios, as you will be. But it is our kids and grandkids who will benefit from the downturn the most, as they won't have to carry as much of our Boomer debt burdens into the future.

Harry

Got a question or comment? You can contact us at info@hsdent.com.