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First Trust

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Monday Morning Outlook

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A Shift in Our Fed Rate Outlook

Early this year, it was our belief (and forecast) that the Federal Reserve would start lifting interest rates from their current level of near zero by mid-year 2010. Our view has been that zero percent interest rates are too low, that the economy would be (and is) in recovery, and that inflationary pressures would continue to increase.

Even though all of this is still true, the Fed has made it clear in recent months that they are willing to hold interest rates down for a period of time that is much more "extended" than we had thought. As a result, we now believe the Fed could continue holding rates at current levels through the end of 2010.

As is typical of the Fed, it has not done a very good job of explaining itself. What we mean by this is that the Fed tries to tell the market what it might do (stop buying mortgages, shrink its balance sheet), but does not tell the market *why* it will do these things.

Here's what we think. The Fed is operating right now using two tools – the Taylor Rule and historical precedent. The Taylor Rule (invented by John Taylor at Stanford) uses a mathematical formula of inflation and growth to set a target federal funds rate. Last year, because GDP fell so sharply in the Panic, the model said a "neutral" federal funds rate was between negative 2% and negative 6%.

In other words, zero percent interest rates weren't low enough, according to the model. Even with the funds rate at rock bottom, the Fed thought it was still too tight. Historical precedent – the Great Depression of the 1930s or Japan in the 1990s – created fears of a similar deflationary spiral. And because the Fed could not cut rates into negative territory, the Fed got serious about expanding its balance sheet. By pushing the balance sheet to more than $2 trillion, the Fed was attempting to use "helicopter money" to boost the economy – what many at the Fed felt was the only option.

Now that the economy is growing again and deflation has been avoided, the Fed thinks its policies have been successful. So, it wants to reverse course. What this means is that it will shrink its balance sheet first and then raise interest rates later.

For two reasons, we view this as a mistake. First, we think the Taylor Rule has made a mistake. As many of our readers know, we use a model for determining a neutral federal funds rate that is based on the two-year change in nominal GDP. This model never dipped into negative territory. In fact, one version of the model says rates never needed to fall below 1%.

Second, the expansion of the Fed's balance sheet is not the same as helicopter money. There are two ways to expand the balance sheet – print new money and buy assets or borrow money from other people and buy assets. The vast majority of the increase in the Fed's balance sheet was due to borrowing, not printing.

Putting these two ideas together leaves us with an entirely different perspective than the Fed. First, the Fed was never as tight as the Taylor Rule suggested. Second, it was not the balance sheet expansion that lifted growth. Third, as growth picks up and nominal GDP increases (as it is doing today) the Fed is much easier than it thinks.

Unfortunately, the Fed does not see it this way and will continue to hold interest rates down for longer than necessary. This means that interest rates will remain lower this year than we originally thought, but that inflation (and commodity prices) will eventually rise even more than we have forecast. The good news is that the stock market and economy will continue to be lifted on a sea of liquidity.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-17 / 7:30 am	Empire State Mfg Index - May	30.0	**30.0**		31.9
5-18 / 7:30 am	PPI – Apr	+0.1%	**+0.1%**		+0.7%
7:30 am	"Core" PPI – Apr	+0.1%	**+0.1%**		+0.1%
7:30 am	Housing Starts - Apr	0.650 Mil	**0.673 Mil**		0.626 Mil
5-19 / 7:30 am	CPI - Apr	+0.1%	**+0.1%**		+0.1%
7:30 am	"Core" CPI - Apr	+0.1%	**+0.1%**		+0.0%
5-20 / 7:30 am	Initial Claims - May 15	440K	**440K**		444K
9:00 am	Philly Fed Survey - May	21.6	**23.1**		20.2
9:00 am	Leading Indicators - Apr	+0.2%	**+0.1%**		+1.4%