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First Trust

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Monday Morning Outlook

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The Taylor Rule Is Wrong

The working hypothesis of just about every forecaster or Fed-watcher in the world has been that the Fed would not tighten at all until 2012. That meant no interest rate hikes this year. And to avoid putting on any brakes at all, the Fed would even think about QE-III. But this view is now coming under fire, not just from the private sector, but from inside the Fed itself.

Stronger gains in employment, along with some relatively hot inflation reports have pushed many regional Fed presidents to make hawkish statements. Charles Plosser, Philadelphia Fed President, said recently that the Fed might need to head for the "exit ramp." Jeffrey Lacker, Richmond Fed President, said he would "not be surprised" if action were taken to fight inflation before the end of the year. James Bullard, St. Louis Fed President, said "U.S. monetary policy cannot remain ultra-accommodative" and hinted about tightening this year. Narayana Kocherlakota, Minneapolis Fed President, said it was "certainly possible" that interest rates could be lifted in late 2011.

For the record, we think the Fed is way behind the curve and that accelerating inflation over the next few years is already baked in the cake. However, the Washington-based board of the Federal Reserve holds the opposite view. They believe inflation is not a problem at all and it has plenty of time to tighten policy before it becomes an issue.

So, here are a few questions we get about this issue: Why is there such a diversity of opinion? How can so-called "smart people" disagree so much? What does the Fed see that we don't? Let's try to answer.

The Fed, even though it won't say it publicly, is putting a great deal of stock in the "Taylor Rule." This rule, created by John Taylor at Stanford, says a "neutral" federal funds rate can be calculated by a formula that considers the divergence of the real GDP growth rate and inflation from certain targets (click here for a general description of the Taylor Rule, and click here for a history of the Taylor Rule).

In recent years, this model (depending on which inflation measure is used) has signaled the need for a *negative* federal funds rate. At the worst of the crisis the Taylor Rule said rates should have been negative 5% or 6%. And some versions of the model signal the need for negative rates right now. This has been the impetus behind Quantitative Easing (QE). If interest rates should be negative, but clearly can't be so, then some other form of easing is necessary, right?

The problem with this is that the Taylor Rule can be, and in our opinion has been, wrong.

In 1993, at virtually the same time John Taylor was building his rule, Brian Wesbury discovered that using a simple two-year annualized rate of growth of nominal GDP provided a robust target for the federal funds rate. This model explained the inflation of the 1970s and the disinflation of the 1980s and 1990s. If the Fed holds rates below nominal GDP it is too loose. If it holds rates above nominal GDP it is too tight.

Back in 2004, this nominal GDP model showed that Alan Greenspan's policy of 1% interest rates was inappropriate. The model said interest rates should have never fallen below 4% or so. No wonder there was overinvestment in housing. Interest rates were misleadingly low – they fooled people into thinking credit was cheaper than it really was.

The same thing is happening today. Two-year annualized nominal GDP growth is 2.4%, but the effective federal funds rate is 0.14%. This model never pointed to the need for sharply negative interest rates (as the Taylor Rule did) and has been positive for all of 2010. In other words, the Fed is (and has been) excessively accommodative. There was no need for QE-II, and there is absolutely no need for QE-III.

Even John Taylor has backed away from the version of his rule that the Fed is using. We agree and think the Fed should use the nominal GDP rule instead. If it did, the Fed would tighten policy this year as many regional Fed Presidents seem to desire.

Of course, Ben Bernanke does not see things the same way we do. He believes in his version of the Taylor Rule and also thinks the economy has a great deal of slack that will let it accelerate without creating inflation. As a result, even though QE-III is off the table, the Fed will continue to ignore the nominal GDP rule and hold rates steady for the rest of 2011. As a result, growth and inflation will continue to accelerate in the quarters ahead.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-5 / 9:00 am	ISM Non-Man. - Mar	59.5	**60.0**		59.7
4-7 / 7:30 am	Initial Claims - Mar 2	385K	**387K**		388K
2:00 pm	Consumer Credit - Feb	+$4.8 Bil	**+$5.0 Bil**		+$5.0 Bil

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.