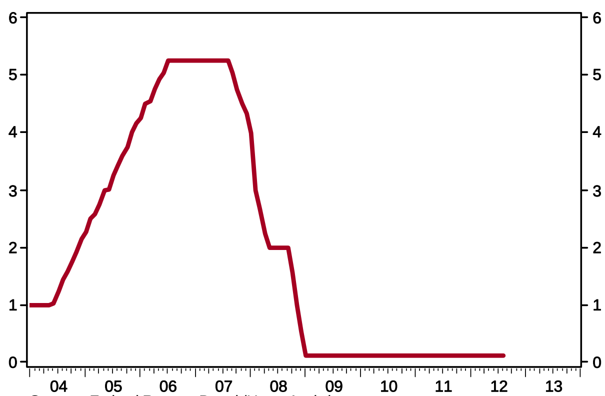
First Trust ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Senior Economist*
Strider Elass – *Economic Analyst*
September 13, 2012 • 630.517.7756 • www.ftportfolios.com

Fed Sets Sail on QE3

They did it. The Federal Reserve today announced a third round of quantitative easing, making an *open-ended* commitment to buy additional mortgage-backed securities at a pace of $40 billion per month. The Fed said it also will "closely monitor" the economy and financial markets and continue these purchases and possibly expand them until they see substantial improvement in the outlook for the labor market.

An open-ended program means QE3 will last as long as the Fed wants and we cannot be sure when it will end. However, at $40 billion per month, it is smaller on a monthly basis than the last round of quantitative easing, which was about $70 billion per month.

Federal Open Market Committee: Fed Funds Target Rate
%



Source: Federal Reserve Board /Haver Analytics

Besides another round of quantitative easing, the Fed also changed its time frame before it expects to change the near-zero short-term federal funds rate to mid-2015 from a previous projection of late-2014. In conjunction with this timing shift, the Fed made it clear that it now thinks it will maintain near-zero rates for a "considerable time" after any strengthening in the economic recovery. Based on the new economic projections from the Fed, it appears to be saying that the federal funds rate will remain where it is until the unemployment rate is at or very close to 6%.

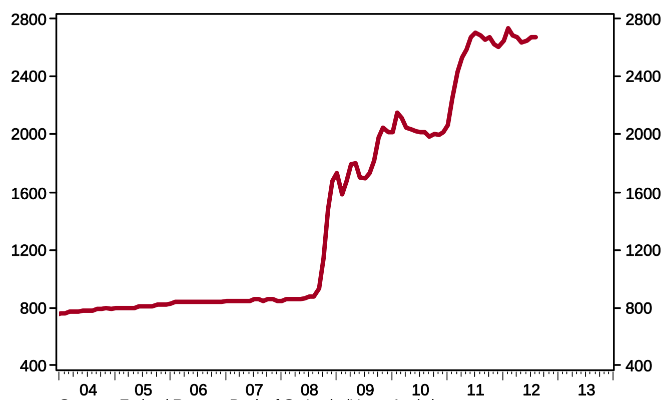
In the context of these major policy decisions, the Fed also made some changes to the language of its statement. The Fed said the economy had "expanded at a moderate pace," rather than "decelerated," acknowledged improvements in household spending, but also noticed deceleration in the growth of business investment.

The Fed's explanation for QE3 was that without it economic growth might not be strong enough to generate sustained improvement in the labor market. In other words, the Fed is now focused mainly on the labor market as a gauge of the performance of the underlying economy.

The one minor point in favor of those concerned about inflation was that the Fed was explicit about saying it had a 2% inflation objective. Of course, for the time being, that objective appears subordinate to the goal of a faster improvement in the labor market. And in his press conference the Chairman admitted that he would accept higher inflation temporarily.

Once again, the lone dissent from the Fed's statement was from Richmond Fed President Jeffrey Lacker, who opposed both QE3 and the description of a time frame before the Fed would raise rates.

St. Louis Fed Adjusted Monetary Base
SA, Bil.$



Source: Federal Reserve Bank of St. Louis /Haver Analytics

Our bottom line remains that QE3 will simply add to the already enormous excess reserves in the bank system, not deal with the underlying causes of economic weakness, including the growth in government spending, excessive regulation, and expectations of higher future tax rates. QE3 will not add anything to economic growth and, as long as banks are reluctant to lend aggressively, not cause any hyper-inflation either.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Senior Economist*

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in August suggests that economic activity has continued to expand at a moderate pace in recent months. Growth in employment has been slow, and the unemployment rate remains elevated. Household spending has continued to advance, but growth in business fixed investment appears to have slowed. The housing sector has shown some further signs of improvement, albeit from a depressed level. Inflation has been subdued, although the prices of some key commodities have increased recently. Longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee is concerned that, without further policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions. Furthermore, strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee also anticipates that inflation over the medium term likely would run at or below its 2 percent objective.

To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee agreed today to increase policy accommodation by purchasing additional agency mortgage-backed securities at a pace of $40 billion per month. The Committee also will continue through the end of the year its program to extend the average maturity of its holdings of securities as announced in June, and it is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. These actions, which together will increase the Committee's holdings of longer-term securities by about $85 billion each month through the end of the year, should put downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

The Committee will closely monitor incoming information on economic and financial developments in coming months. If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability. In determining the size, pace, and composition of its asset purchases, the Committee will, as always, take appropriate account of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens. In particular, the Committee also decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Dennis P. Lockhart; Sandra Pianalto; Jerome H. Powell; Sarah Bloom Raskin; Jeremy C. Stein; Daniel K. Tarullo; John C. Williams; and Janet L. Yellen. Voting against the action was Jeffrey M. Lacker, who opposed additional asset purchases and preferred to omit the description of the time period over which exceptionally low levels for the federal funds rate are likely to be warranted.