First Trust
Monday Morning OUTLOOK
September 17th, 2012

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QE3, For Now

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As we all know by now, the Federal Reserve launched QE3 on Thursday, announcing an open-ended program of buying an extra $40 billion a month in mortgage-backed securities until it sees a substantial improvement in the outlook for the labor market. It also adjusted its guidance for when it thinks it will start moving up short-term interest rates to mid-2015 from a previous late-2014.

Behind the scenes, we think the Fed is trying to close the gap between where the economy is today and where the Fed thinks it should be.

If nominal GDP – which includes real GDP and inflation – had grown at a 4.5% annual rate since mid-2007, it would be almost 12% higher than it actually is today. To close that gap, the Fed wants to see nominal GDP growing consistently above 4.5%. For example, a 6.5% nominal GDP growth rate would have to last for almost six years to fully close the gap.

This would be consistent with what economist, and Ben Bernanke-confidante, Ken Rogoff has suggested, which is that the Fed should let inflation run a little higher than normal to help dilute debts and lift underwater homeowners.

If this insight is right, that this is what Bernanke is thinking, then even if the real economy and inflation rise like we are forecasting, which is more aggressive than the Fed, then the Fed really isn't going to raise rates until 2015.

That said, it's important to take all of these timeframes with a grain of salt. Think back to 2004 or 2007. Although everyone knew back in 2004 that rates would go up eventually, the exact timing and extent of those changes were up in the air. And the Fed certainly wasn't talking about near zero percent short-term rates in mid-2007. In other words, monetary policy will continue to be data dependent.

And, if so, there are reasons to discount the Fed's forward commitment. Ironically, by extending its commitment to keep short-term rates near zero, the Fed may encourage banks to more aggressively lend out the excess reserves the Fed has sold them. If so, this could generate an acceleration in economic growth that the Fed would respond to by reversing direction on its forward commitment, bringing the first rate hike sooner rather than later.

Another catalyst for moving up rate hikes could be an election that resulted in both more policy certainty and a better direction on spending, tax, and regulatory issues.

A further complication to this whole issue is what the Fed has done to the credit markets, which total about $55 trillion. Going back to the late 1980s, the Fed's balance sheet was generally around 2% of total credit market debt. This is debt owed by the government, households, and businesses, combined. Now the Fed's balance sheet has swelled to more than 5% of total debt.

When the Fed finally starts to unwind this enormous intervention in the financial markets, we may be experiencing much more inflation than we are right now. Once again, this may force the Fed to react more aggressively than normal, sending interest rates higher across a wide range of products, not just Treasury securities.

The bottom line is that, while today it may look like a long time before the Fed will eventually raise rates, the whole debate about monetary policy could shift over the next few years.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-17 / 7:30 am	Empire State Mfg Index – Aug	-2.0	**-5.0**	-10.4	-5.9
9-19 / 7:30 am	Housing Starts – Aug	0.760 Mil	**0.754 Mil**		0.746 Mil
9:00 am	Existing Home Sales – Aug	4.553 Mil	**4.490 Mil**		4.470 Mil
9-20 / 7:30 am	Initial Claims – Sep 15	370K	**375K**		382K
9:00 am	Leading Indicators – Aug	-0.1%	**+0.0%**		+0.4%
9:00 am	Philly Fed Survey – Sep	-4.0	**-7.8**		-7.1

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.