First Trust
ECONOMIC RESEARCH REPORT
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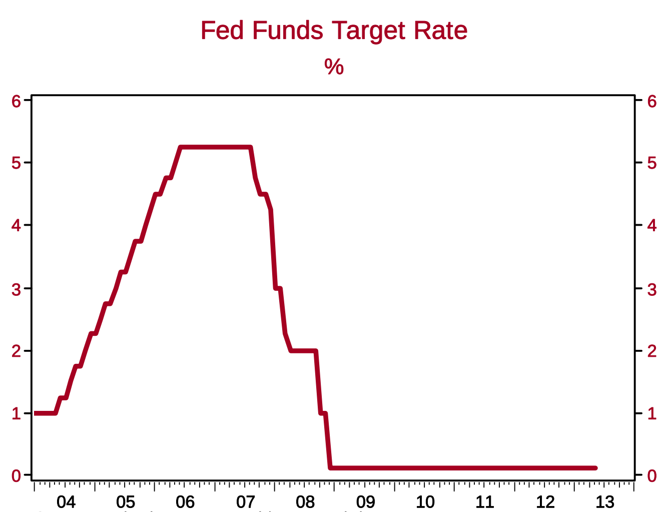
Fed Doesn't Budge

It would be hard to find a policy statement from the Federal Reserve with as few changes as the one issued today. The Fed made no changes to monetary policy and only minor changes to the language of its statement. Even the lone dissent, from Kansas City Fed Bank President Esther George, was a carbon copy from the last statement in March.

On the economy itself, the Fed added a few words suggesting a more tepid recovery in the labor market, consistent with last month's report of softer growth in payrolls. The Fed also suggested more confidence that fiscal policy is restraining economic growth. We think this confidence is misplaced. The Fed, which is often obsessed with the "wealth effect" from the stock market, ignored that the S&P 500 was up 5.5% since the federal spending sequester went into effect. That's more than $500 billion in household wealth. Applying a modest 5% propensity to consume out of this wealth, suggests added spending of $25 billion, more than half of the total sequester-related spending cuts through the end of September.



Source: Federal Reserve Board /Haver Analytics

On monetary policy, the Fed added a sentence saying that it "is prepared to increase or reduce the pace of (asset) purchases…as the outlook for the labor market or inflation changes." Others might make a big deal out of this, but we think it is not a shift in policy at all. By now, every investor should have known that the Fed, which is already on its third round of quantitative easing, might increase asset purchases if they don't get the data they want to see.

As we have written many times before, QE3 is simply adding to the already enormous excess reserves in the banking system, not dealing with the underlying causes of economic weakness, including the growth in government, 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 hyper-inflation either.

Nominal GDP – real GDP plus inflation – is already growing at around a 3.5% annual rate. At that pace, the economy can already sustain a much higher federal funds rate than now prevails. Maintaining rates near zero percent will eventually lead to inflation running consistently above the Fed's 2% target, which means once it starts raising rates the peak will be higher than 4%, perhaps much higher.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in March suggests that economic activity has been expanding at a moderate pace. Labor market conditions have shown some improvement in recent months, on balance, but the unemployment rate remains elevated. Household spending and business fixed investment advanced, and the housing sector has strengthened further, but fiscal policy is restraining economic growth. Inflation has been running somewhat below the Committee's longer-run objective, apart from temporary variations that largely reflect fluctuations in energy prices. Longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with appropriate policy accommodation, economic growth will proceed at a moderate pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. The Committee continues to see downside risks to the economic outlook. The Committee also anticipates that inflation over the medium term likely will 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 decided to continue purchasing additional agency mortgage-backed *securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $45 billion per month. The Committee 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 and of rolling over maturing Treasury securities at auction. Taken together, these actions should maintain 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. The Committee will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability. The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes. In determining the size, pace, and composition of its asset purchases, the Committee will continue to take appropriate account of the likely efficacy and costs of such purchases as well as the extent of progress toward its economic objectives.

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 asset purchase program ends and the economic recovery strengthens. In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Charles L. Evans; Jerome H. Powell; Sarah Bloom Raskin; Eric S. Rosengren; Jeremy C. Stein; Daniel K. Tarullo; and Janet L. Yellen. Voting against the action was Esther L. George, who was concerned that the continued high level of monetary accommodation increased the risks of future economic and financial imbalances and, over time, could cause an increase in long-term inflation expectations.