First Trust
ECONOMIC RESEARCH REPORT

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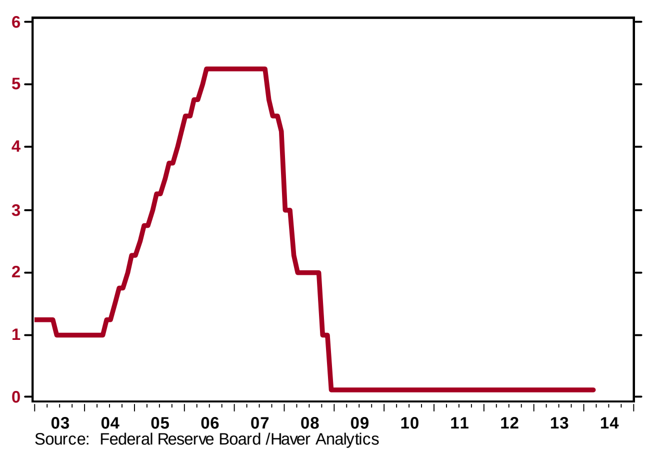
March 19, 2014 • 630.517.7756 • www.ftportfolios.com

Dovish Words, Hawkish Forecast

Today's activity from the Federal Reserve was an odd mix of a slightly more dovish policy statement and a more hawkish set of interest rate projections. It was topped off with the new Fed Chair Janet Yellen's first post-meeting press conference, which simultaneously provided more clarity on when the Fed would eventually raise rates (if the economy behaved as the Fed expects) but less clarity on what would guide the Fed's decisions.

Putting it all together, we haven't changed our outlook on monetary policy, which is that the Fed will probably accelerate the taper of quantitative easing (QE) later this year, ending it around September and start raising short-term rates by the second quarter of 2015.



As expected, the Fed announced it would reduce its monthly purchases of Treasury securities and mortgage-backed securities by another $5 billion each ($10 billion total) to $55 billion starting in April. This follows a tapering of $10 billion announced at each of the two prior meetings in December and January. So the size of the Fed's balance sheet will continue to rise, but slightly more slowly than before.

The Fed made changes to the statement that signal a slightly more dovish outlook for the economy. The Fed thinks the recent slowdown in economic growth may go beyond bad weather. In her press conference, Yellen explained that this simply meant the Fed was retracting the extra optimism it showed in January and was back to the more cautious optimism it held in December. The Fed also added a reference to unemployment remaining "elevated."

The Fed reiterated that the "considerable time" between the end of QE and the start of rate hikes could last longer if inflation remained below 2%. However, at the press conference, Yellen said a "considerable time" should be interpreted as six months. This difference appears to be confusing to some analysts. We think it means that if inflation gradually moves upward, as the Fed now expects, rate hikes will start about six months after tapering ends; if inflation undershoots the Fed's projection, then the interim period will last longer than six months.

As expected, the Fed dropped its reference to begin considering rate hikes when the unemployment rate dropped to 6.5%. But rather than setting a clear new quantitative target, the Fed basically said we'd just have to trust its judgment, and that it would use a "wide range of information" in deciding when to begin those discussions, including data on the labor market, inflation, and the financial markets. If you like discretionary monetary policy – for central bankers to exercise their judgment without clear guideposts – you'll love the Yellen Fed.

The hawkish part of today's Fed decision was in its projection of the future path of short-term interest rates. The median forecast of the members of the FOMC (Federal Open Market Committee) is that the federal funds target will be 1% at the end of 2015 (previously 0.75%) and 2.25% at the end of 2016 (previously 1.75%). Compared to the last projection in December, the new numbers suggest either a slightly earlier start to rate hikes or a slightly more aggressive series of hikes once they start.

But here's where it gets tricky. At the press conference Yellen said not to read much into slight changes in the projected path of short-term interest rates, as that path could change one way or another at each meeting. That may be her way of dismissing the contributions and importance of some of the regional Reserve Bank Presidents and Fed Governors who participate in that public forecast. In other words, she was saying, pay more attention to her statements as well as those of her inner circle, including New York Bank President Bill Dudley and incoming Fed Vice-Chair Stanley Fischer.

The one dissent from today's Fed's statement was by Minnesota Bank President Kocherlakota, who wanted to make it clearer that the Fed wants inflation to get back to 2% and thinks the statement will foster "policy uncertainty." We'll have to wait to see the minutes of the meeting, but we're guessing he didn't like the more subjective determination of when to raise rates and would have preferred more exact numerical targets for both inflation and unemployment.

At the press conference, Yellen mentioned a few labor market indicators she'll be watching in addition to the jobless rate. These include the more comprehensive U-6 measure of unemployment (which includes part-timers who say they want full-time work, as well as discouraged workers), the labor force participation rate, the "quit" rate, and wage growth.

Look for the markets to pursue more clarity from the Fed over the next couple of weeks. In the meantime, the tapering of QE will continue and we expect economic growth to re-accelerate and equities to move higher before the next meeting at the end of April.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in January indicates that growth in economic activity slowed during the winter months, in part reflecting adverse weather conditions. Labor market indicators were mixed but on balance showed further improvement. The unemployment rate, however, remains elevated. Household spending and business fixed investment continued to advance, while the recovery in the housing sector remained slow. Fiscal policy is restraining economic growth, although the extent of restraint is diminishing. Inflation has been running below the Committee's longer-run objective, but 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 activity will expand at a moderate pace and labor market conditions will continue to improve gradually, moving toward those the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for the economy and the labor market as nearly balanced. The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, and it is monitoring inflation developments carefully for evidence that inflation will move back toward its objective over the medium term.

The Committee currently judges that there is sufficient underlying strength in the broader economy to support ongoing improvement in labor market conditions. In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions since the inception of the current asset purchase program, the Committee decided to make a further measured reduction in the pace of its asset purchases. Beginning in April, the Committee will add to its holdings of agency mortgage-backed securities at a pace of $25 billion per month rather than $30 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $30 billion per month rather than $35 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. The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative, which in turn should promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate.

The Committee will closely monitor incoming information on economic and financial developments in coming months and 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. If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings. However, asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's outlook for the labor market and inflation as well as its assessment of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy remains appropriate. In determining how long to maintain the current 0 to 1/4 percent target range for the federal funds rate, the Committee will assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and *provided that longer-term inflation expectations remain well anchored.*

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. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.

With the unemployment rate nearing 6-1/2 percent, the Committee has updated its forward guidance. The change in the Committee's guidance does not indicate any change in the Committee's policy intentions as set forth in its recent statements.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Richard W. Fisher; Sandra Pianalto; Charles I. Plosser; Jerome H. Powell; Jeremy C. Stein; and Daniel K. Tarullo.

Voting against the action was Narayana Kocherlakota, who supported the sixth paragraph, but believed the fifth paragraph weakens the credibility of the Committee's commitment to return inflation to the 2 percent target from below and fosters policy uncertainty that hinders economic activity.