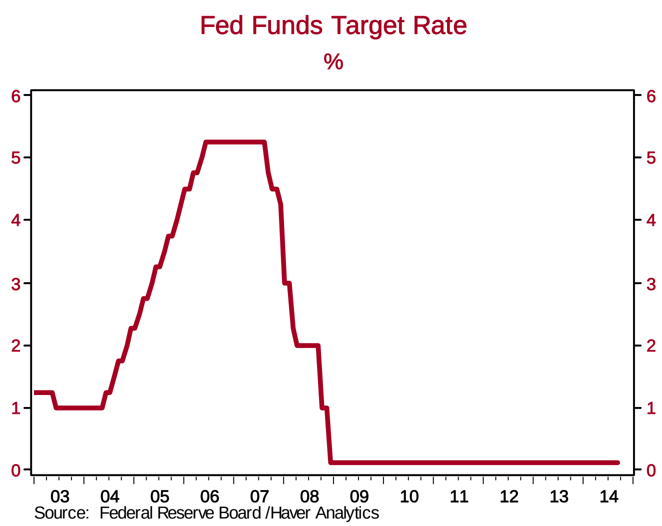
First Trust
ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Economist*
September 17, 2014 • 630.517.7756 • www.ftportfolios.com

Rate Hikes Approaching

We count five major takeaways from today's activity at the Federal Reserve.

First, quantitative easing (QE) still looks on track for winding down at the end of October. As expected, the Fed announced it would cut its purchases of Treasury securities and mortgage-backed securities to $15 billion in October and expects to announce an end to QE at the next meeting, which is October 29th.



Second, the median view among Fed officials is for a slightly faster increase in short-term rates. Back in June, the consensus was for the top of the federal funds target range to be 1.25% at the end of 2015; now it's 1.5%. Previously the consensus was around 2.5% for the end of 2016, now it's 3%. As a result, it now looks like the Fed will start raising rates by April 2015, perhaps even as early as the first quarter. To confirm this, look for the Fed to dump the "considerable time" language later this year.

Third, once it starts raising rates, the Fed will try to control the federal funds rate by using the interest it pays banks for holding excess reserves. It will also use reverse repos to help control the funds rate, but only as much and as long as needed. The Fed says it won't use reverse repos for other purposes.

Fourth, the Fed isn't going to outright sell securities from its portfolio to unwind its bloated balance sheet. After starting to raise the funds rate, the Fed will eventually allow its balance sheet to shrink in a passive way, by letting securities gradually mature without full reinvestment. The Fed is particularly reluctant to sell mortgage-backed securities (MBS), but may eventually do so several years down the road to clean up some long-dated securities on its books that won't mature anytime soon. Long-term, the Fed intends to go back to holding almost all Treasury securities, not a large portfolio of MBS.

Last, where there's smoke, there's fire. Two Fed officials dissented from the statement, both Philadelphia Fed Bank President Charles Plosser and Dallas Bank President Richard Fisher. More importantly, both dissents were from hawks, which suggests that if the Fed makes any changes in policy or projections at the next couple of meetings, it's more likely to get more hawkish than more dovish.

The Fed also made some minor changes to the language in its statement, noting that the unemployment rate is little changed since the last meeting and the economy is expanding moderately after the downside surprise in Q1 and sharp rebound in Q2.

The bottom line is that the Fed has been and will remain behind the curve. Nominal GDP – real GDP growth plus inflation – is up 4.2% in the past year and up at a 3.7% annual rate in the past two years. A federal funds target rate of nearly zero is too low given this growth. It's also too low given well-tailored policy tools like the Taylor Rule.

Hyperinflation is not in the cards; the Fed will keep paying banks enough to keep the money multiplier depressed. But, given loose policy, we expect gradually faster growth in nominal GDP for the next couple of years. In turn, the bull market in equities will continue to prevail and the bond market is due for a fall.

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

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in July suggests that economic activity is expanding at a moderate pace. On balance, labor market conditions improved somewhat further; however, the unemployment rate is little changed and a range of labor market indicators suggests that there remains significant *underutilization of labor resources. Household spending appears to be rising moderately and business fixed investment is advancing, while the recovery in the housing sector remains 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. 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, with labor market indicators and inflation moving toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for economic activity and the labor market as nearly balanced and judges that the likelihood of inflation running persistently below 2 percent has diminished somewhat since early this year.

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 October, the Committee will add to its holdings of agency mortgage-backed securities at a pace of $5 billion per month rather than $10 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $10 billion per month rather than $15 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 end its current program of asset purchases at its next meeting. 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.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Stanley Fischer; Narayana Kocherlakota; Loretta J. Mester; Jerome H. Powell; and Daniel K. Tarullo. Voting against the action were Richard W. Fisher and Charles I. Plosser. President Fisher believed that the continued strengthening of the real economy, improved outlook for labor utilization and for general price stability, and continued signs of financial market excess, will likely warrant an earlier reduction in monetary accommodation than is suggested by the Committee's stated forward guidance. President Plosser objected to the guidance indicating 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," because such language is time dependent and does not reflect the considerable economic progress that has been made toward the Committee's goals..