First Trust
ECONOMIC RESEARCH REPORT

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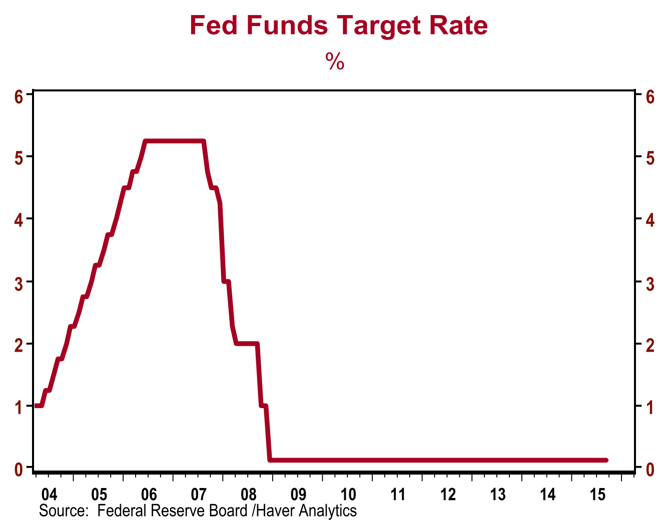
Yellen Flinches

It is long past time for the Federal Reserve to start raising short-term rates. The unemployment rate is already very close to the Fed's (new, lower) long-term projection of 4.9% and set to fall further in the next year, even if the Fed had already started lifting rates. Nominal GDP growth – real GDP growth plus inflation – is up at a 4.1% annual rate in the past two years, slightly exceeding the Fed's long-run projection of 4% growth.

Regardless, the Fed left short-term rates unchanged at today's meeting and issued, on net, a more dovish statement than after the last meeting in July. Although the Fed acknowledged better business investment, it also provided three reasons for keeping rates unchanged, including (1) lower market-based measures of inflation, (2) global economic developments (which means China-related issues) and (3) financial developments (the recent correction in equity prices).



We don't think any of these factors warranted a longer wait for rate hikes. There's always going to be some excuse to postpone rate hikes. The longer the Fed waits the more likely it is that the US economy eventually requires the kind of aggressive rate hikes that can cause a future recession. Raising rates by 25 basis points today wasn't going to stop anyone from fracking a well or inventing a new App.

In addition to the dovish statement, the Fed slightly marked down its estimates for the long-run average unemployment rate as well as inflation for the next few years. Both of these changes give the Fed more room to temporarily justify keeping rates unchanged.

Consistent with the changes in the economic outlook, the median forecast from the Fed's key decision-makers is that the Fed will only raise rates by 25 basis points this year, versus a prior median forecast of 50 basis points. In addition, the median estimate of the long run average federal funds rate fell to 3.5% from a prior estimate of 3.75%.

The one bright spot in today's statement was that Richmond Fed Bank President Jeffrey Lacker dissented. He would have raised rates by 25 basis points today.

So where does that leave the likely course of monetary policy over the next several months? We believe a rate hike by the end of this year is still likely, but not a slam dunk. The next Fed meeting is in late October. But we see third quarter real GDP growth coming in at about a 2% annual rate. And it's hard to see a Fed so skittish that it didn't raise rates today willing to raise rates in that environment. Instead, December is more likely than October. By that time we should have some indications that real GDP is accelerating in the fourth quarter. However, we also can't completely dismiss the possibility of the Fed waiting until 2016.

The smartest investors know that the starting time for rate hikes is much less important than how high rates will ultimately go. In that sense, today's news was a sideshow and we expect more aggressive rate hikes in 2016 than the Fed and markets now anticipate.

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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. Household spending and business fixed investment have been increasing moderately, and the housing sector has improved further; however, net exports have been soft. The labor market continued to improve, with solid job gains and declining unemployment. On balance, labor market indicators show that underutilization of labor resources has diminished since early this year. Inflation has continued to run below the Committee's longer-run objective, partly reflecting *declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation moved lower; survey-based measures of longer-term inflation expectations have remained stable.*

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term. Nonetheless, the Committee expects that, with appropriate policy accommodation, economic activity will expand at a moderate pace, with labor market indicators continuing to move toward levels the Committee judges consistent with its dual mandate. The Committee continues to see the risks to the outlook for economic activity and the labor market as nearly balanced but is monitoring developments abroad. Inflation is anticipated to remain near its recent low level in the near term but the Committee expects inflation to rise gradually toward 2 percent over the medium term as the labor market improves further and the transitory effects of declines in energy and import prices dissipate. The Committee continues to monitor inflation developments closely.

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that the current 0 to 1/4 percent target range for the federal funds rate remains appropriate. In determining how long to maintain this target range, 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 and international developments. The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen some further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term.

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. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

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; Charles L. Evans; Stanley Fischer; Dennis P. Lockhart; Jerome H. Powell; Daniel K. Tarullo; and John C. Williams. Voting against the action was Jeffrey M. Lacker, who preferred to raise the target range for the federal funds rate by 25 basis points at this meeting.