First Trust
ECONOMIC RESEARCH REPORT

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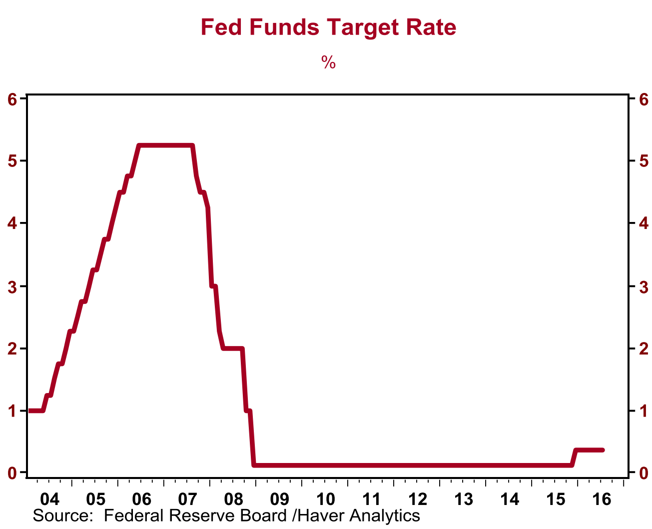
Despite a Wimpy Fed, September Hike on the Table

Mark your calendars for a rate hike on September 21st. Today's statement was much more hawkish than the June statement and Esther George, the Kansas City Fed Bank President, hopped back on the dissent train in favor of hiking rates by 25 basis points at today's meeting.

The Fed tilted towards tightening in three areas of today's statement. First, they said "the labor market strengthened," and that "on balance, payrolls and other labor market indicators point to some increase in labor utilization in recent months." This comes in contrast to last month, when the one off weakness of the May employment report led to a knee-jerk overreaction by the Fed as they fretted about slower improvement in the labor market. Second, the Fed noted that "economic activity has been expanding at a moderate rate," meaning the economy continues to grow. Third, it was clear last month in Fed Chief Janet Yellen's post-meeting press conference that the Fed was worried about outside forces effecting economic growth in the U.S. (think Brexit). Today, the Fed added in extra text stating that "near-term risks to the economic outlook have diminished."



Taken together, we believe the Federal Reserve is starting to signal that it intends to raise rates by 25 basis points at the next meeting, consistent with the projections it made in June that it would still raise rates twice in 2016. This suggests one hike next meeting and then one at the end of the year after the election. But this is by no means guaranteed. Today's statement stopped short of adding specific language suggesting a rate hike is imminent, like it did in October 2015, when it referred to the "next meeting" and then followed through, raising rates that December.

In our view, economic fundamentals warrant a rate hike as soon as possible (we would have liked at least once already in 2016). The economy can handle higher short-term rates. The unemployment rate is already very close to the Fed's long-term projection of 4.8% and nominal GDP – real GDP growth plus inflation – has grown at a 3.6% annual rate in the past two years. Moreover, we are starting to see early signs of accelerating inflation. "Core" consumer prices are up 2.3% versus a year ago, tied with the largest increase since 2008.

Slightly higher short-term rates are not going to derail US growth, but will help avoid the misallocation of capital that's inevitable if short-term rates remain artificially low.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in June indicates that the labor market strengthened and that economic activity has been expanding at a moderate rate. Job gains were strong in June following weak growth in May. On balance, payrolls and other labor market indicators point to some increase in labor utilization in recent months. Household spending has been growing strongly but business fixed investment has been soft. Inflation has continued to run below the Committee's 2 percent longer-run objective, partly reflecting earlier declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation remain low; most survey-based measures of longer-term inflation expectations are little changed, on balance, in recent months.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market indicators will strengthen. Inflation is expected to remain low in the near term, in part because of earlier declines in energy prices, but to rise to 2 percent over the medium term as the transitory effects of past declines in energy and import prices dissipate and the labor market strengthens further. Near-term risks to the economic outlook have diminished. The Committee continues to closely monitor inflation indicators and global economic and financial developments.

Against this backdrop, the Committee decided to maintain the target range for the federal funds rate at 1/4 to 1/2 percent. The stance of monetary policy remains accommodative, thereby supporting further improvement in labor market conditions and a return to 2 percent inflation.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to 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. In light of the current shortfall of inflation from 2 percent, the Committee will carefully monitor actual and expected progress toward its inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

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, and it anticipates doing so until normalization of the level of the federal funds rate is well under way. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; James Bullard; Stanley Fischer; Loretta J. Mester; Jerome H. Powell; Eric Rosengren; and Daniel K. Tarullo. Voting against the action was Esther L. George, who preferred at this meeting to raise the target range for the federal funds rate to 1/2 to 3/4 percent.