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First Trust

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Economic Commentary

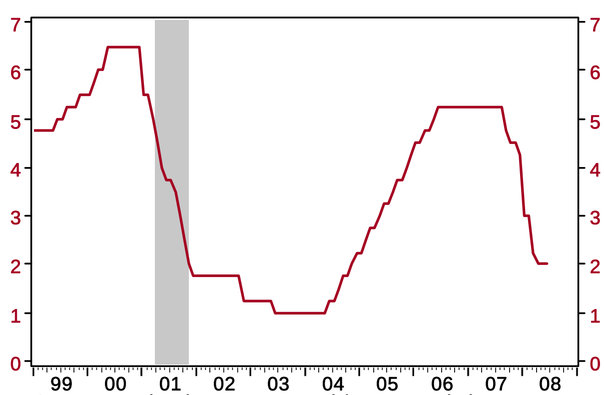
August Tightening On the Table

Today's statement from the Federal Reserve is consistent with our view that it will raise rates starting at the meeting on August 5. Although a rate hike at the August meeting is not guaranteed, it will be hard for the Fed to refrain from raising rates unless economic growth slows or inflation suddenly declines between now and then, neither of which we expect.

The Fed left interest rates unchanged today, with the target federal funds rate at 2.00% and the discount rate at 2.25%. However, it made major changes to its statement on the economy, indicating less concern about growth and more concern about inflation. We interpret these changes as a "bias" toward lifting rates at future meetings.

Fed Funds Target Rate

%



Source: Federal Reserve Board /Haver Analytics

On economic growth, the Fed statement contained a few big changes.

(1) In April, the Fed said economic activity "remains weak." Today the Fed said economic activity "continues to expand." This new language means the Fed now thinks the economy *never* contracted, which means there was no recession. It also signals a clear upgrade to the Fed's internal economic projections.

(2) In April, the Fed said household and business spending were "subdued." Now it describes household spending as "firming" and omitted the reference to weak business spending.

(3) In April, the Fed said the housing correction was "deepening." Now it's described as "ongoing," which is milder language.

Regarding inflation, the Fed statement was much more hawkish.

(1) April's reference to improved readings on core inflation was removed.

(2) In April the Fed said that "some indicators of inflation expectations have risen." Now it says these indicators are "elevated," which is a more aggressive assessment.

(3) The Fed omitted language it used in April that lower resource utilization could reduce inflation. In other words, the Fed now thinks inflation could remain troublesome, and require higher rates, even if the unemployment rate stays at 5.5%.

Consistent with the changes to the paragraphs on economic growth and inflation, the Fed altered the paragraph on the "balance of risks" by noting "diminished" downside risks to economic growth and "upside" risks to inflation *and* inflation expectations.

Worthy of note was that Dallas Fed President Richard Fisher – who would have preferred no rate reduction in April when the Fed cut the funds rates for a final time to 2% – dissented from today's decision too, preferring an increase in the funds rate. This suggests that even the much more hawkish language was unable to fully convey the fear of inflation at the Fed.

Text of the Federal Reserve's Statement:

The Federal Open Market Committee decided today to keep its target for the federal funds rate at 2 percent.

Recent information indicates that overall economic activity continues to expand, partly reflecting some firming in household spending. However, labor markets have softened further and financial markets remain under considerable stress. Tight credit conditions, the ongoing housing contraction, and the rise in energy prices are likely to weigh on economic growth over the next few quarters.

The Committee expects inflation to moderate later this year and next year. However, in light of the continued increases in the prices of energy and some other commodities and the elevated state of some indicators of inflation expectations, uncertainty about the inflation outlook remains high.

The substantial easing of monetary policy to date, combined with ongoing measures to foster market liquidity, should help to promote moderate growth over time. Although downside risks to growth remain, they appear to have diminished somewhat, and the upside risks to inflation and inflation expectations have increased. The Committee will continue to monitor economic and financial developments and will act as needed to promote sustainable economic growth and price stability.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; Timothy F. Geithner, Vice Chairman; Donald L. Kohn; Randall S. Kroszner; Frederic S. Mishkin; Sandra Pianalto; Charles I. Plosser; Gary H. Stern; and Kevin M. Warsh. Voting against was Richard W. Fisher, who preferred an increase in the target for the federal funds rate at this meeting.

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