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First Trust

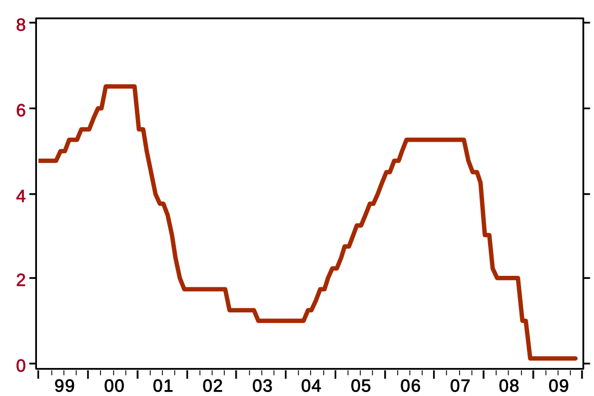
Dec 16, 2009

Economic Commentary

Fed Inching Toward Higher Rates

The Federal Reserve made no direct changes to the stance of monetary policy today, leaving the target range for the federal funds rate at 0% to 0.25%. However, the language of the statement included several notable changes that recognized better economic prospects and provided information on the winding down of special liquidity facilities.

On the economy, the Fed said consumer spending is "expanding at a moderate rate" rather than just "expanding" and that income growth is "modest" rather than "sluggish." In addition, although the Fed said "firms remain reluctant to add to payrolls," it acknowledged that "the deterioration in the labor market is abating" and omitted a reference in the November statement to businesses cutting back on staffing. Also, the Fed said financial markets are now "supportive" of economic growth. The Fed made no changes to its statement on inflation.



The other changes in today's statement deal with the special credit facilities established after the collapse of Lehman Brothers. Most prominently, the Fed removed a sentence that had been in *every* statement since December 2008 that it would "employ a wide range of tools" to promote economic recovery and preserve price stability. Next, although it reserved the right to change its mind, the Fed made it clear that it was neither expanding the credit amounts in the facilities or time frame related to the facilities. Instead, it plans on winding them down as previously scheduled, which for most of them means early 2010.

Given our forecast that the unemployment rate will decline more than the Fed anticipates in 2010 and underlying inflation trends will continue to accelerate we think today's statement is consistent with higher short-term interest rates starting in the Spring or early Summer.

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

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in November suggests that economic activity has continued to pick up and that the deterioration in the labor market is abating. The housing sector has shown some signs of improvement over recent months. Household spending appears to be expanding at a moderate rate, though it remains constrained by a weak labor market, modest income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment, though at a slower pace, and remain reluctant to add to payrolls; they continue to make progress in bringing inventory stocks into better alignment with sales. Financial market conditions have become more supportive of economic growth. Although economic activity is likely to remain weak for a time, the Committee anticipates that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a strengthening of economic growth and a gradual return to higher levels of resource utilization in a context of price stability.

With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain subdued for some time.

The Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable *inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve is in the process of purchasing $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt. In order to promote a smooth transition in markets, the Committee is gradually slowing the pace of these purchases, and it anticipates that these transactions will be executed by the end of the first quarter of 2010. The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets.*

In light of ongoing improvements in the functioning of financial markets, the Committee and the Board of Governors anticipate that most of the Federal Reserve's special liquidity facilities will expire on February 1, 2010, consistent with the Federal Reserve's announcement of June 25, 2009. These facilities include the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, the Commercial Paper Funding Facility, the Primary Dealer Credit Facility, and the Term Securities Lending Facility. The Federal Reserve will also be working with its central bank counterparties to close its temporary liquidity swap arrangements by February 1. The Federal Reserve expects that amounts provided under the Term Auction Facility will continue to be scaled back in early 2010. The anticipated expiration dates for the Term Asset-Backed Securities Loan Facility remain set at June 30, 2010, for loans backed by new-issue commercial mortgage-backed securities and March 31, 2010, for loans backed by all other types of collateral. The Federal Reserve is prepared to modify these plans if necessary to support financial stability and economic growth.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Charles L. Evans; Donald L. Kohn; Jeffrey M. Lacker; Dennis P. Lockhart; Daniel K. Tarullo; Kevin M. Warsh; and Janet L. Yellen.