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First Trust

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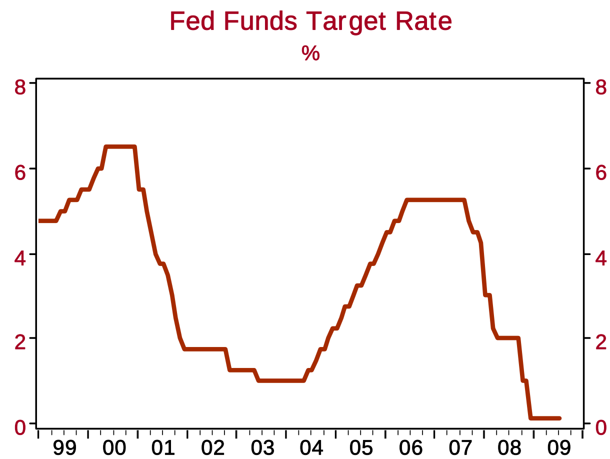
Economic Commentary

Fed More Optimistic, But Stays Loose

The Federal Reserve did not make any direct changes to the stance of monetary policy yesterday. The target range for the federal funds rate remains 0% to 0.25%, where it has been since late last year.

However, the Fed made some noteworthy changes to the language of its statement, acknowledging improvement in the economic and financial situation. First, the Fed said economic activity is "leveling out" rather than simply falling at a slower rate. Second, the Fed said financial market conditions have improved since June. Third, the Fed showed growing confidence that businesses have made progress in reducing excess inventories, saying they "are" doing so, rather than "appear to be" doing so, which is the language from the previous statement in June.

On inflation, the Fed made zero changes to its language, changing not one word.



In terms of the special credit facilities to deal with the financial panic, the Fed said it believes its commitment to buy $300 billion in Treasury securities will be completed by late October. This was less of a change in policy than a confirmation of what investors already anticipated.

We are pleased the Fed showed less bearishness about the economy but don't think it went far enough. Real GDP growth is going to be positive in the third quarter and the recession is over. Both initial and continuing claims for unemployment insurance are down substantially from where they were earlier this year. Housing starts are starting to rebound from artificially low levels, exports are growing again, and consumption is reviving. Meanwhile, commodity prices are up significantly from where they were earlier this year. Even used car prices have spiked upward in recent months, despite a "cash-for-clunkers" program that should be steering buyers toward new cars, not used ones.

As a result, we were disappointed that the Fed made no gesture at all toward weakening or removing the language that it will keep the federal funds rate at exceptionally low levels for "an extended period." It will not be an extended period of time at all before economic conditions warrant increases in the federal funds rate. The Fed is waiting too long to prepare investors for the inevitable rate hikes that will begin early next year.

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 June suggests that economic activity is leveling out. Conditions in financial markets have improved further in recent weeks. Household spending has continued to show signs of stabilizing but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment and staffing but are making progress in bringing inventory stocks into better alignment with sales. Although economic activity is likely to remain weak for a time, the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to *a gradual resumption of sustainable economic growth in a context of price stability.*

The prices of energy and other commodities have risen of late. However, substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time.

In these circumstances, the Federal Reserve will employ all available tools to promote economic recovery and to preserve price stability. 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 are likely to warrant exceptionally low levels of the federal funds rate for an extended period. As previously announced, to provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of up to $1.25 trillion of agency mortgage-backed securities and up to $200 billion of agency debt by the end of the year. In addition, the Federal Reserve is in the process of buying $300 billion of Treasury securities. To promote a smooth transition in markets as these purchases of Treasury securities are completed, the Committee has decided to gradually slow the pace of these transactions and anticipates that the full amount will be purchased by the end of October. 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. The Federal Reserve is monitoring the size and composition of its balance sheet and will make adjustments to its credit and liquidity programs as warranted.

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.

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