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First Trust

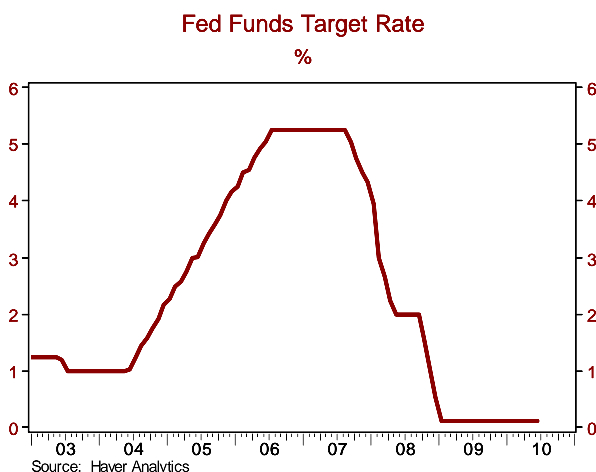
Jun 23, 2010 Economic Commentary

The Fed Flies with the Doves

As everyone expected, 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%. Also as expected, it made no changes to its commitment to keep short-term interest rates at this level for an "extended period."

Minor changes to the statement suggest the Fed is, on net, *more* concerned about economic growth and *less* concerned about inflation than at the last meeting April. Regarding the pace of economic growth, the changes versus the statement in April, include the following:

(1) The economic recovery is "proceeding" rather than "continued to strengthen."
(2) The labor market is "improving gradually" rather than "beginning to improve."
(3) Commercial construction is "weak" rather than "declining."
(4) Housing starts are at a "depressed level" rather than have "edged up."
(5) Financial conditions are "less supportive of economic growth" rather than "remain supportive of economic growth."



On inflation, the Fed acknowledged that commodity prices have declined and went out of its way to say that "underlying inflation has trended lower." It is true that core consumer prices, which exclude food and energy, are up 0.9% in the past twelve months while this number was 1.1% as of the Fed meeting two months ago. But in the past three months these same core prices are up at a 0.8% annual rate compared to a *decline* at a 0.2% annual rate as of the meeting in April. In other words, the Fed did not have to add the language about a drop in the underlying trend in inflation to this meeting's statement. That they did anyhow suggests very little concern by Chairman Bernanke about inflation.

The one "hawkish" element in today's statement was that, despite recent financial concerns regarding Europe, Kansas City Fed Bank President Thomas Hoenig repeated his three prior dissents, saying not only that the "extended period" language is no longer warranted but also that continuing to use such language could limit the Fed's flexibility to raise rates.

Despite a recent spate of tepid data that seems to have influenced the Fed, we believe that the recovery will remain robust. Real GDP grew at a 3.9% annual rate in the second half of 2009 and is likely to grow at about that rate again in the first half of 2010. Nominal GDP – real GDP growth plus inflation – grew at a 4.3% rate in the second half of 2009 and is likely to accelerate further. A federal funds rate of essentially 0% is not appropriate for an economy with positive and rising nominal GDP growth.

However, the Fed has made it abundantly clear, through what it has said and what it has not said, that rates are going nowhere at least through the end of this year. At present, we do not expect any change in the federal funds rate until March 2011. A more prolonged period of extremely loose monetary policy will generate more real economic growth in 2011. However, once again, like in the decade just ended, the Fed looks committed to stay too loose for too long. We will eventually pay a price for the Fed's unwillingness to raise rates sooner rather than later. That price will include higher inflation and faster rate hikes in 2011-12, as well as an ultimate peak for rates that is higher than it could have been.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in April suggests that the economic recovery is proceeding and that the labor market is improving gradually. Household spending is increasing but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on

equipment and software has risen significantly; however, investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls. Housing starts remain at a depressed level. Financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad. Bank lending has continued to contract in recent months. Nonetheless, the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, although the pace of economic recovery is likely to be moderate for a time.

Prices of energy and other commodities have declined somewhat in recent months, and underlying inflation has trended lower. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to be 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.

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to promote economic recovery and price stability.
Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Donald L. Kohn; Sandra Pianalto; Eric S. Rosengren; Daniel K. Tarullo; and Kevin M. Warsh. Voting against the policy action was Thomas M. Hoenig, who believed that continuing to express the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted because it could lead to a build-up of future imbalances and increase risks to longer-run macroeconomic and financial stability, while limiting the Committee's flexibility to begin raising rates modestly.

This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.