First Trust
ECONOMIC RESEARCH REPORT

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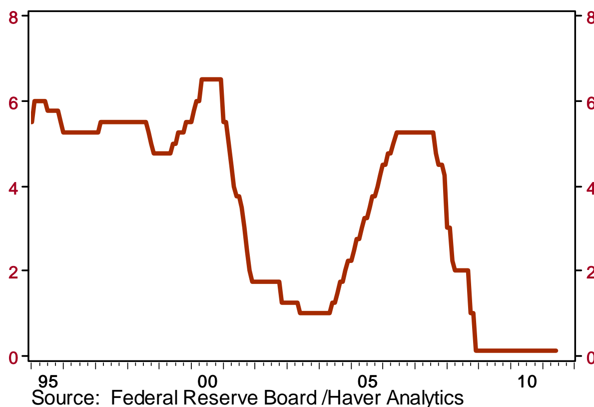
Fed Gets Slightly More Hawkish on Inflation, More Dovish on Growth

Today's official statement from the Federal Reserve included small changes indicating it is slightly more hawkish on inflation but also a bit more concerned about economic growth.

On inflation, the Fed said higher commodity prices were a factor behind the temporary slower pace of the economic recovery and deleted a reference to "subdued" measures of underlying inflation. We believe the deletion acknowledges that core consumer prices, which exclude food and energy, are up at a 2.5% annual rate in the past three months.

On the economy, the Fed said growth had slowed down versus its forecast but thinks much of this is a temporary result of higher commodity prices as well as supply-chain disruptions due to the disasters in Japan. The Fed added language to the statement saying it "expects the pace of recovery to pick up over coming quarters and the unemployment rate to resume its gradual decline."



Source: Federal Reserve Board /Haver Analytics

However, the Fed was careful to say – and this was repeated by Chairman Bernanke in his press conference – that the recent slowdown in growth was only "in part" due to temporary factors. Bernanke said longer-term factors could be at work as well. In addition, the Fed's new set of economic projections show it thinks real GDP will grow at a 3.5% rate next year versus a prior central forecast of 3.85%. Related to this, the Fed thinks the unemployment rate will finish 2012 at 8% versus a prior forecast of 7.75%. The projected jobless rate at the end of 2013 was also moved up by a quarter percentage point. However, the Fed did not change its view of the "natural rate" of unemployment, which it still pegs at 5.4%. So whatever long-term factors the Fed is thinking might be slowing the economy now, those factors are not structural.

On the second round of quantitative easing, the Fed made it official that it was ending the program at the end of June, as previously scheduled. It also made it explicit that it will, for the time being, reinvest principal proceeds from its maturing securities holdings in order to maintain the size of its portfolio. In his press conference, Bernanke made it clear the Fed thinks ending the full reinvestment of these proceeds – as opposed to raising the federal funds rate – would be the first step toward a tighter monetary policy.

Otherwise, as everyone expected, the Fed 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%. In addition, the Fed maintained its pledge to keep the funds rate at this level for an "extended period," which Bernanke explained in his press conference means at least two or three meetings (equal to three to five months). This is a slight change to what Bernanke said at the prior press conference, when he said the commitment meant two meetings.

As we wrote following the Fed meeting two months ago, in our view the economy is already in the position to handle higher short-term rates. But we are obviously not in charge. Looking at today's statement, the press conference, as well as the changes in the Fed's economic forecast, suggests the Fed will not start raising rates until at least mid-2012, and perhaps much later than that. Higher inflation – and not just for commodities – will be the inevitable result.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in April indicates that the economic recovery is continuing at a moderate pace, though somewhat more slowly than the Committee had expected. Also, recent labor market indicators have been weaker than anticipated. The slower pace of the recovery reflects in part factors that are likely to be temporary, including the damping effect of higher food and energy prices on consumer purchasing power and spending as well as

supply chain disruptions associated with the tragic events in Japan. Household spending and business investment in equipment and software continue to expand. However, investment in nonresidential structures is still weak, and the housing sector continues to be depressed. Inflation has picked up in recent months, mainly reflecting higher prices for some commodities and imported goods, as well as the recent supply chain disruptions. However, longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The unemployment rate remains elevated; however, the Committee expects the pace of recovery to pick up over coming quarters and the unemployment rate to resume its gradual decline toward levels that the Committee judges to be consistent with its dual mandate. Inflation has moved up recently, but the Committee anticipates that inflation will subside to levels at or below those consistent with the Committee's dual mandate as the effects of past energy and other commodity price increases dissipate. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations.

To promote the ongoing economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent. The Committee continues to anticipate that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate for an extended period. The Committee will complete its purchases of $600 billion of longer-term Treasury securities by the end of this month and will maintain its existing policy of reinvesting principal payments from its securities holdings. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

The Committee will monitor the economic outlook and financial developments and will act as needed to best foster maximum employment and price stability.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Charles L. Evans; Richard W. Fisher; Narayana Kocherlakota; Charles I. Plosser; Sarah Bloom Raskin; Daniel K. Tarullo; and Janet L. Yellen.

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.