First Trust ECONOMIC RESEARCH REPORT

Brian S. Wesbury – Chief Economist
Robert Stein, CFA – Dep. Chief Economist
Strider Elass – Economist

December 18, 2013 • 630.517.7756 • www.ftportfolios.com

A Dovish-Bullish Taper

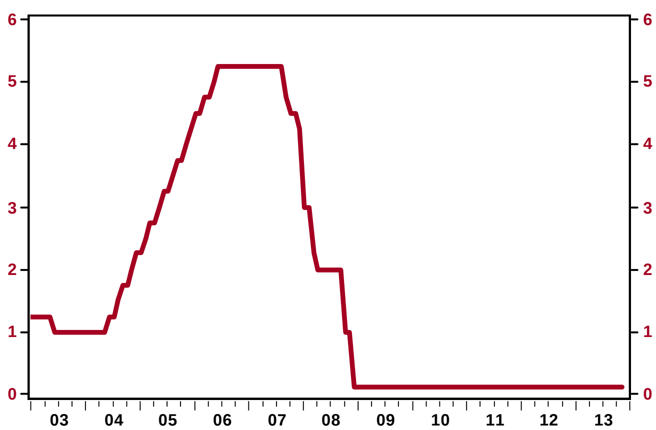
They finally did it. At Chairman Bernanke's next to last meeting, the Federal Reserve announced a modest tapering of quantitative easing, reducing its monthly purchases of Treasury securities and mortgage-backed securities by $5 billion each ($10 billion total) to $75 billion starting in January. As a result, the size of the Fed's balance sheet will continue to rise, but slightly more slowly than before.

Slowing the pace of QE was not the only change by the Fed, which issued a statement that was, simultaneously, more bullish about the economy and more aggressive about keeping short-term interest rates near zero.

Notably, the strong positive equity market reaction to today's announcement severely undermines the argument that it was QE supporting the stock market the past few years. Expectations about the amount of any remaining QE are clearly lower today than they were yesterday, and yet stocks are up substantially. If QE was supporting equities, less QE should mean a lower stock market, not higher.

Fed Funds Target Rate

%



Source: Federal Reserve Board /Haver Analytics

The Fed said today that if the economy continues to behave as it expects, with an improving labor market and inflation moving toward 2%, that we should expect further tapering in QE in "measured steps at future meetings." In theory, with eight meetings in 2014 and QE starting the year at $75 billion per month, the process of eliminating QE could take all year. However, given the First Trust economic forecast – real GDP growth of about 3% next year with inflation of about 2% – we anticipate that QE will end around mid-2014.

The more bullish language in today's statement included more direct language on expanding economic activity, an acknowledgement that unemployment "has declined," and a comment that the (supposedly) negative effects of fiscal policy "may be diminishing." The Fed also said the risks to the economic outlook have "become more nearly balanced." Prior statements emphasized downside risks to the economy, although less so at the last meeting in October.

Despite more bullish language on the economy, the Fed added a new sentence to its statement, saying it now foresees the federal funds rate staying near zero "well past the time that the unemployment rate declines below 6.5%." The Fed also added language making this commitment even more important if inflation remains below 2%.

The one dissent at today's meeting was by Boston Fed Bank President Eric Rosengren, who did not want to taper at this meeting and is still concerned about elevated unemployment and inflation too far below 2%. Kansas City Fed President Esther George, who had dissented at prior meetings because monetary policy was too loose, voted in favor of today's Fed statement.

As we have written before, QE, by itself, has not boosted economic growth or equity prices. Instead, it has simply added to enormous excess reserves in the banking system. The Fed has used QE as way to signal keeping short-term interest rates low. Now the Fed has evidence it can generate this signal without QE. Expect less and less QE as we move into 2014, even as equities keep trending higher.

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

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in October indicates that economic activity is expanding at a moderate pace. Labor market conditions have shown further improvement; the unemployment rate has declined but remains elevated. Household spending and business fixed investment advanced, while the recovery in the housing sector slowed somewhat in recent months. Fiscal policy is restraining economic growth, although the extent of restraint may be diminishing. Inflation has been running below the Committee's longer-

run objective, but longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with appropriate policy accommodation, economic growth will pick up from its recent pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for the economy and the labor market as having become more nearly balanced. The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, and it is monitoring inflation developments carefully for evidence that inflation will move back toward its objective over the medium term.

Taking into account the extent of federal fiscal retrenchment since the inception of its current asset purchase program, the Committee sees the improvement in economic activity and labor market conditions over that period as consistent with growing underlying strength in the broader economy. In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions, the Committee decided to modestly reduce the pace of its asset purchases. Beginning in January, the Committee will add to its holdings of agency mortgage-backed securities at a pace of $35 billion per month rather than $40 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $40 billion per month rather than $45 billion per month. The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative, which in turn should promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate.

The Committee will closely monitor incoming information on economic and financial developments in coming months and will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability. If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings. However, asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's outlook for the labor market and inflation as well as its assessment of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. The Committee also reaffirmed its expectation that the current exceptionally low target range for the federal funds rate of 0 to 1/4 percent will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee now anticipates, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Charles L. Evans; Esther L. George; Jerome H. Powell; Jeremy C. Stein; Daniel K. Tarullo; and Janet L. Yellen. Voting against the action was Eric S. Rosengren, who believes that, with the unemployment rate still elevated and the inflation rate well below the federal funds rate target, changes in the purchase program are premature until incoming data more clearly indicate that economic growth is likely to be sustained above its potential rate.