First Trust
ECONOMIC RESEARCH REPORT
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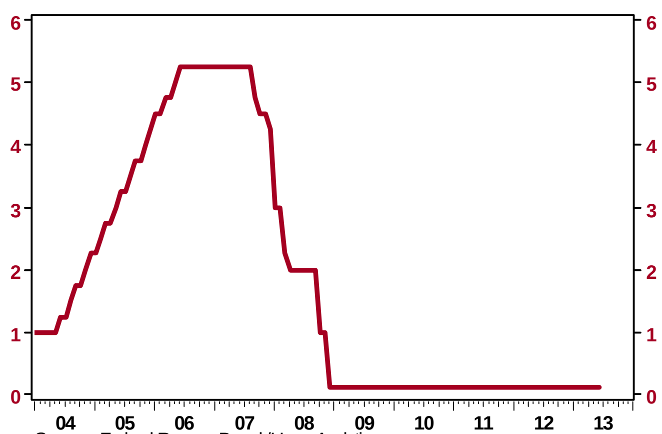
Fed Slightly More Optimistic

The Federal Reserve made only slight changes to the text of its statement, but those it did make signal slightly more optimism. It said labor market conditions show "further improvement," rather than "some improvement" and sees "diminished" downside risks for the broader economy.

Normally, slightly more optimism on the economy should be taken as a "hawkish" sign for monetary policy. However, today's statement was devoid of any hints of a tapering of quantitative easing. In addition, we now have a new "dovish" dissenter, St. Louis Fed Bank President James Bullard, who wants the Fed to focus more on its inflation goal given recent inflation readings below the long-term target of 2%. Meanwhile, Kansas City Fed Bank President Esther George continued to dissent against a policy she believes is overly accommodative.



In the press conference following the release of the statement, Chairman Bernanke provided some clarification of the current policy consensus at the Fed.

- First, the Fed views a 6.5% unemployment rate as a "threshold" for raising the federal funds rate, not an automatic trigger. So, for example, if the jobless rate drops to 6.5% and the Fed's inflation projections remain *below* its long-term target of 2%, it will be slower to raise rates than if its inflation projections were running *at or above* 2%.

- Second, quantitative easing would end when the jobless rate falls to 7%.

- Third, there would be a "considerable" time lag between the end of quantitative easing and deciding to raise the federal funds rate. The use of the word "considerable" probably refers to a period somewhere from six to twelve months.

- Fourth, the Fed believes once it starts raising rates it will do so gradually, which probably means 25 basis points per meeting (2 percentage points per year), or less.

The Fed also made several notable changes to its economic forecast. It very slightly reduced real GDP growth this year, but added that growth into 2014. It made larger changes to its unemployment projections, cutting the rate for the end of this year to about 7.25% and cutting the rate at the end of next year to about 6.65%. The Fed also reduced its inflation projections for 2013-15.

Taking the Fed's new economic projections at face value, it appears it now expects to end quantitative easing around May 2014 and start raising rates around April/May 2015. But we think these events will happen earlier. We project a 7% unemployment rate for December 2013, so an end to quantitative easing should be announced by the January meeting. Meanwhile, we are projecting a 6.5% unemployment rate in the third quarter of 2014.

One more item of note was that Bernanke said when the Fed gets around to selling off assets, it would *not* sell Mortgage-Backed Securities, implying it would only work with Treasury securities. In the end, we think the whole issue of selling assets will be less controversial and less interesting than many now fear. Once the Fed raises rates, it will automatically sell Treasury securities to banks and offset these sales by reducing banks' excess reserves, which now total $1.9 trillion.

Either way, as we have written many times before, QE3 is simply adding to the already enormous excess reserves in the banking system, not dealing with the underlying causes of economic weakness, including growth in government, excessive regulation, and expectations of higher future tax rates. QE3 does not add anything to economic growth and, as long as banks are reluctant to lend aggressively, does not cause hyper-inflation either.

Nominal GDP – real GDP plus inflation – is already growing at around a 3.5% annual rate. At that pace, the economy can already sustain a much higher federal funds rate than now prevails. Maintaining rates near zero percent will eventually lead to inflation running consistently above the Fed's 2% target, which means once it starts raising rates the peak will be higher than 4%, perhaps much higher.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in May suggests that economic activity has been expanding at a moderate pace. Labor market conditions have shown further improvement in recent months, on balance, but the unemployment rate remains elevated. Household spending and business fixed investment advanced, and the housing sector has strengthened further, but fiscal policy is restraining economic growth. Partly reflecting transitory influences, 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 proceed at a moderate pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. The Committee sees the downside risks to the outlook for the economy and the labor market as having diminished since the fall. The Committee also anticipates that inflation over the medium term likely will run at or below its 2 percent objective.

To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee decided to continue purchasing additional agency mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $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. Taken together, these actions should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

The Committee will closely monitor incoming information on economic and financial developments in coming months. The Committee 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. The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes. In determining the size, pace, and composition of its asset purchases, the Committee will continue to take appropriate account of the likely efficacy and costs of such purchases as well as the extent of progress toward its economic objectives.

To support continued progress toward maximum employment and price stability, the Committee expects 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. In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate 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. 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; Elizabeth A. Duke; Charles L. Evans; Jerome H. Powell; Sarah Bloom Raskin; Eric S. Rosengren; Jeremy C. Stein; Daniel K. Tarullo; and Janet L. Yellen. Voting against the action was James Bullard, who believed that the Committee should signal more strongly its willingness to defend its inflation goal in light of recent low inflation readings, and Esther L. George, who was concerned that the continued high level of monetary accommodation increased the risks of future economic and financial imbalances and, over time, could cause an increase in long-term inflation expectations.