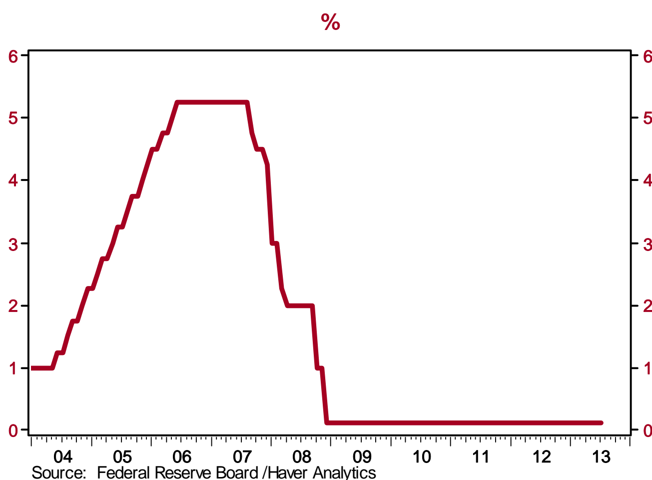
First Trust
ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Economist*
July 31, 2013 • 630.517.7756 • www.ftportfolios.com

Fed Shows Its Dovish Side

The Federal Reserve made several small changes to the text of its statement, which, combined, suggest a slightly more dovish posture at this meeting than at the last one in June.

First, the Fed said the expansion of economic activity was "modest," rather than "moderate." Second, it added a reference to rising mortgage rates in a way that suggested some concern it could slow the housing recovery. Third, the Fed added language saying "inflation persistently below its 2%" target could hurt the economy. And last, the Fed highlighted its intention to maintain near zero interest rates for a "considerable time" after the end of quantitative easing. The one change that was more hawkish was an assertion that growth would "pick up from its recent pace" rather than "proceed at a moderate pace."



Like the last statement in June, today's lacked any hints of when a tapering of quantitative easing would begin. Meanwhile, Kansas City Fed Bank President Esther George continued to dissent against a policy she believes is overly accommodative. St. Louis Fed bank President James Bullard, who dissented in June because he wanted a more dovish statement voted for the statement this month. Bullard likely ended his dissent because of the new language on sub-2% inflation hurting the economy.

Notably absent from the statement was any change to the unemployment thresholds the Fed has used to guide the markets, such as 6.5% for starting to consider interest rate hikes or 7% for ending quantitative easing.

We project a 7% unemployment rate for early next year, so an end to quantitative easing announced at the meeting in March 2014. Meanwhile, we are projecting a 6.5% unemployment rate in the third or fourth quarter of 2014.

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. Notably, former Treasury Secretary Lawrence Summers, now being considered for the Fed chairmanship, appears to share our view on the ineffectiveness of quantitative easing.

Nominal GDP – real GDP plus inflation – is up at a 3.7% annual rate in the past two years. 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 for fed funds will be higher than the 4% the Fed now projects, perhaps much 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 June suggests that economic activity expanded at a modest pace during the first half of the year. 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 been strengthening, but mortgage rates have risen somewhat and 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 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 downside risks to the outlook for the economy and the labor market as having diminished since the fall. The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, but it anticipates that inflation will move back toward its objective over the medium term.

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 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. 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; James Bullard; 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 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.

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.