First Trust

ECONOMIC RESEARCH REPORT

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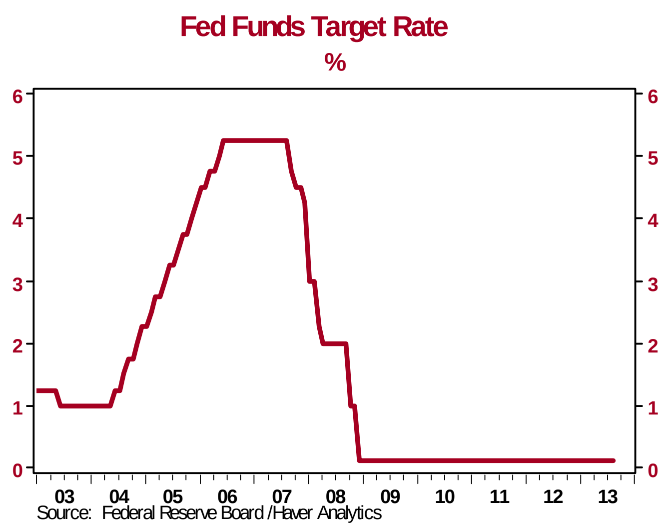
September 18, 2013 • 630.517.7756 • www.ftportfolios.com

Yellen Takes Over

Today's statement and (lack of) policy changes from the Federal Reserve was about as dovish as investors could imagine. The statement from the Fed reads as if Chairman Bernanke handed the pen to Vice-Chair Janet Yellen and let her write it instead, which makes sense if he knows something the rest of us don't – about her chances for being elevated to the top spot in the near future.

The big issue going into the meeting was whether the Fed would reduce, or "taper," the pace of net asset purchases from the current rate of $85 billion per month. The consensus was for a reduction of $10-15 billion per month; instead, the Fed didn't taper at all.



The Fed wrote that the pace of asset purchases was "not on a preset course." This implicitly rejected Bernanke's own words at the June press conference that quantitative easing would be finished around the time unemployment hit 7%. When asked about the 7% trigger today, Bernanke treated his old statement like it had the plague, saying there was "no fixed schedule" and "not any magic number" for ending QE, and, that the unemployment rate itself is not a great measure for the state of the labor market.

In other words, don't expect QE to be over when the jobless rate hits 7%, which the Fed now thinks will happen in March 2014. In terms of when tapering might start, the Fed said it wants to see ongoing improvement in the labor market and an inflation rate moving closer to the Fed's 2% target.

The Fed meets again in late October but we doubt that will be enough time for the Fed to change its views on tapering. Instead, we think the very earliest the Fed will start tapering is the December meeting, and then only if it sees some clear and unambiguous acceleration in economic growth.

Given our economic forecast, which is that real GDP growth will accelerate to near 3% at an annual rate in Q4 and continue into 2014, we expect the Fed to taper and then wind down quantitative easing by mid-2014.

For today, the Federal Reserve made several other changes to the text of the statement, all of which were more dovish. It noted higher interest rates and said they could slow economic growth and the pace of improvement in the labor market. The Fed also added language that suggests an increase in inflation from current levels would be more consistent with the Fed's dual mandate. All in all, the Fed set the stage for a much easier monetary policy going forward than it had led the markets to believe over the past three months. So much for transparency.

The one dissent at the meeting was by Kansas City Fed Bank President Esther George, who continued to say policy is overly accommodative.

In addition to releasing its statement, the Fed also provided a new set of economic projections as well as an internal poll on the most likely course for interest rates. Highlights include the following:

- The Fed cut its forecast for real GDP growth this year to slightly more than 2% (from about 2.5%). It also cut next year by a ¼ point to 3%.

- The Fed cut its estimate of the long-term average unemployment rate to 5.5% from 5.6%.

- Only three members (out of 17) thought rates should go up in 2014, versus four members in June.

- The median federal funds target for the end of 2015 was 0.75% versus 1% back in June.

Based on today's statement, lack of policy changes, and the sense that Vice Chairman of the Fed, Janet Yellen, seems to have the inside track to getting the nomination, it looks like, the federal funds rate is not going anywhere until 2015. The Fed's projections say the funds rate will still be about 1.75% in late 2016. And, in his press conference, Bernanke said that it would take two or three more years after 2016 for the funds rate to get back to a more normal 4%.

As we have written many times before, QE3 is not boosting growth, but, instead, is simply adding to the already enormous excess reserves in the banking system. There is little evidence that QE has lifted growth and Price-to-Earnings ratios remain below their levels in early 2008, before QE ever started.

QE is not dealing with the underlying causes of economic weakness at all. The economy has grown slowly, not because of deleveraging, or a recovery from financial problems, but because government is too big. Spending, regulation, and tax rates have all become a bigger burden on the economy – a wet blanket on recovery that the Fed cannot possibly offset.

The good news is that entrepreneurs never give up. New technology continues to left growth. One can only hope that the Fed does not eventually ruin what is left of innovation and creativity by creating too much inflation.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in July suggests that economic activity has been expanding at a moderate pace. Some indicators of labor market conditions have shown further improvement in recent months, 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 further and fiscal policy is restraining economic growth. Apart from fluctuations due to changes in energy prices, 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, on net, since last fall, but the tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and labor market. 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.

Taking into account the extent of federal fiscal retrenchment, the Committee sees the improvement in economic activity and labor market conditions since it began its asset purchase program a year ago as consistent with growing underlying strength in the broader economy. However, the Committee decided to await more evidence that progress will be sustained before adjusting the pace of its purchases. Accordingly, 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, 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. In judging when to moderate the pace of asset purchases, the Committee will, at its coming meetings, assess whether incoming information continues to support the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective. Asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's economic outlook 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. 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; Charles L. Evans; Jerome H. Powell; 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.