First Trust ECONOMIC RESEARCH REPORT

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

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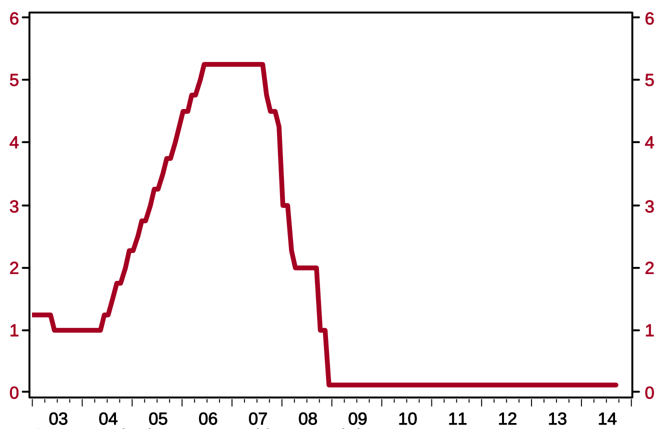
Fed Ends QE, Rate Hikes Now on Radar

We count five key takeaways from today's policy statement from the Federal Reserve.

First, the Fed clearly <u>raised its assessment of the economy</u>. Most notably, it deleted its long-standing reference to "significant underutilization" in the labor market, changing it to say that the underutilization in the labor market is "gradually diminishing." This may not seem like much, but at the Yellen Fed a better assessment of the job market is a necessary step before raising rates and that hurdle is now much closer to being cleared. In addition, the Fed strengthened its language on consumer spending and completely deleted a reference to fiscal policy restraining economic growth.

Fed Funds Target Rate

%



Source: Federal Reserve Board /Haver Analytics

Second, <u>quantitative easing is finished by the end of the week</u>, as previously projected. This doesn't mean the Fed's balance sheet will suddenly go back to normal. Instead, the Fed will keep reinvesting principal payments from its holdings to maintain the balance sheet at roughly $4.4 trillion. Look for the Fed to keep reinvesting principal through at least late 2015.

Third, the Fed is <u>taking a more nuanced view on inflation</u>, comparing market-based measures (such as the five-year forward inflation rate), which have diminished recently, to survey-based measures, which have remained stable. The Fed pointed out that energy prices should hold inflation down in the near term but inflation should still head back up toward its target of 2%.

Fourth, <u>the Fed maintained its commitment to keep rates at current levels for a "considerable time</u>," but added language saying rate hikes could happen sooner or later depending on how closely actual economic data match its forecast. We think this means the Fed is getting very close to removing the "considerable period" phrase. Look for the Fed to remove the language at the mid-December meeting, when Chairwoman Yellen will have a chance to fully explain the Fed's reasoning at the post-meeting press conference.

Last, <u>the two hawkish dissenters at the September meeting are now back on board with Fed policy while the lone dissent at today's meeting was a dovish one</u> from Minneapolis Fed president Narayana Kocherlakota, who wants the Fed to commit to keeping rates low until inflation hits 2% and wants to keep quantitative easing going at the current slow pace at least through the end of the year.

The bottom line is that the Fed has been and will remain behind the curve. We believe the first rate hike could come in the second quarter of next year. But nominal GDP – real GDP growth plus inflation – is up 4.3% in the past year and up at a 3.8% annual rate in the past two years. A federal funds target rate of nearly zero is too low given this growth. It's also too low given well-tailored policy tools like the Taylor Rule.

In the meantime, hyperinflation is not in the cards; the Fed will keep paying banks enough to keep the money multiplier depressed. But, given loose policy, we expect gradually faster growth in nominal GDP for the next couple of years. In turn, the bull market in equities will continue and the bond market is due for a fall.

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 September suggests that economic activity is expanding at a moderate pace. Labor market conditions improved somewhat further, with solid job gains and a lower unemployment rate. On balance, a range of labor market indicators suggests that underutilization of labor resources is gradually diminishing. Household spending is rising moderately and *business fixed investment is advancing, while the recovery in the housing sector remains slow. Inflation has continued to run below the Committee's longer-run objective. Market-based measures of inflation compensation have declined somewhat; survey-based measures of 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 activity will expand at a moderate pace, with labor market indicators and inflation moving toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for economic activity and the labor market as nearly balanced. Although inflation in the near term will likely be held down by lower energy prices and other factors, the Committee judges that the likelihood of inflation running persistently below 2 percent has diminished somewhat since early this year.

The Committee judges that there has been a substantial improvement in the outlook for the labor market since the inception of its current asset purchase program. Moreover, the Committee continues to see sufficient underlying strength in the broader economy to support ongoing progress toward maximum employment in a context of price stability. Accordingly, the Committee decided to conclude its asset purchase program this 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. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that the current 0 to 1/4 percent target range for the federal funds rate remains appropriate. In determining how long to maintain this target range, the Committee will assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee anticipates, based on its current assessment, that it likely will be appropriate to maintain the 0 to 1/4 percent target range for the federal funds rate for a considerable time following the end of its asset purchase program this month, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored. However, if incoming information indicates faster progress toward the Committee's employment and inflation objectives than the Committee now expects, then increases in the target range for the federal funds rate are likely to occur sooner than currently anticipated. Conversely, if progress proves slower than expected, then increases in the target range are likely to occur later than currently anticipated.

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. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Stanley Fischer; Richard W. Fisher; Loretta J. Mester; Charles I. Plosser; Jerome H. Powell; and Daniel K. Tarullo. Voting against the action was Narayana Kocherlakota, who believed that, in light of continued sluggishness in the inflation outlook and the recent slide in market-based measures of longer-term inflation expectations, the Committee should commit to keeping the current target range for the federal funds rate at least until the one-to-two-year ahead inflation outlook has returned to 2 percent and should continue the asset purchase program at its current level.