First Trust
ECONOMIC RESEARCH REPORT

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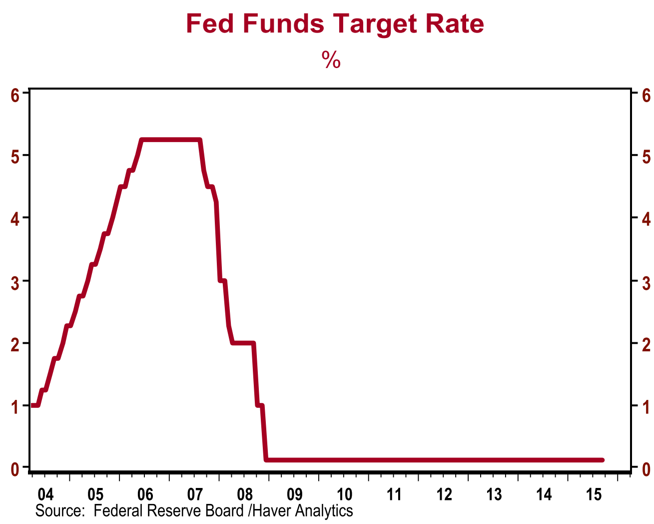
Fed Sets Stage For December Rate Hike

Today's statement from the Federal Reserve sets the stage for a December rate hike. The key issue is whether the next two reports on the labor market, the one coming out late next week and the one released in early December, show a reacceleration in jobs gains or continued drops in the unemployment rate. At present, we expect both, which suggests the Fed will start a long-awaited series of rate hikes in December.

Two major changes to the Fed's statement hint at a Fed rate hike. First, the Fed took out the reference to global economic and financial developments possibly restraining economic growth and putting downward pressure on inflation. In other words, like some investors, it was too concerned at the September meeting with what was going on in China.



Second, when listing the factors that would guide its decision on interest rates – progress toward maximum employment and 2% inflation – the Fed didn't refer to "how long" it would maintain its current target for short-term rates. Instead, the Fed said it would use these factors "(i)n determining whether it will be appropriate to raise the target range at its next meeting". That's pretty specific. They had been using the prior open-ended language, with no specific meeting reference, dating back to December 2012. We see that as a big shift and a key signal to the markets.

The Fed made two other less important changes to the statement. It acknowledged that the pace of job gains has been slower lately, but also noted better growth in consumer spending and business investment. We think these two relatively minor changes offset each other, one more hawkish, the other more dovish.

It is long past time for the Federal Reserve to start raising short-term rates. The unemployment rate is already very close to the Fed's (new, lower) long-term projection of 4.9% and set to fall further in the next year, even if the Fed had already started lifting rates. Nominal GDP growth – real GDP growth plus inflation – is up at a 4.1% annual rate in the past two years, slightly exceeding the Fed's long-run projection of 4% growth.

At least one voting member at the Fed agrees. Once again, Richmond Fed Bank President Jeffrey Lacker dissented from today's statement; he would have raised rates by 25 basis points today. However, it now looks increasingly likely that Lacker can stick to his position and won't have to dissent in December.

As long as the data cooperate, look for a 25 basis point rate hike in December followed by a rate hike at every other meeting, four rate hikes in all, in 2016.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in September suggests that economic activity has been expanding at a moderate pace. Household spending and business fixed investment have been increasing at solid rates in recent months, and the housing sector has improved further; however, net exports have been soft. The pace of job gains slowed and the unemployment rate held steady. Nonetheless, labor market indicators, on balance, show that underutilization of labor resources has diminished since early this year. Inflation has continued to run below the Committee's longer-run objective, partly reflecting declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation moved slightly lower; 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 continuing to *move toward levels the Committee judges consistent with its dual mandate. The Committee continues to see the risks to the outlook for economic activity and the labor market as nearly balanced but is monitoring global economic and financial developments. Inflation is anticipated to remain near its recent low level in the near term but the Committee expects inflation to rise gradually toward 2 percent over the medium term as the labor market improves further and the transitory effects of declines in energy and import prices dissipate. The Committee continues to monitor inflation developments closely.*

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 whether it will be appropriate to raise the target range at its next meeting, 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 and international developments. The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen some further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term.

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.

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; Charles L. Evans; Stanley Fischer; Dennis P. Lockhart; Jerome H. Powell; Daniel K. Tarullo; and John C. Williams. Voting against the action was Jeffrey M. Lacker, who preferred to raise the target range for the federal funds rate by 25 basis points at this meeting.