First Trust
ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Economist*
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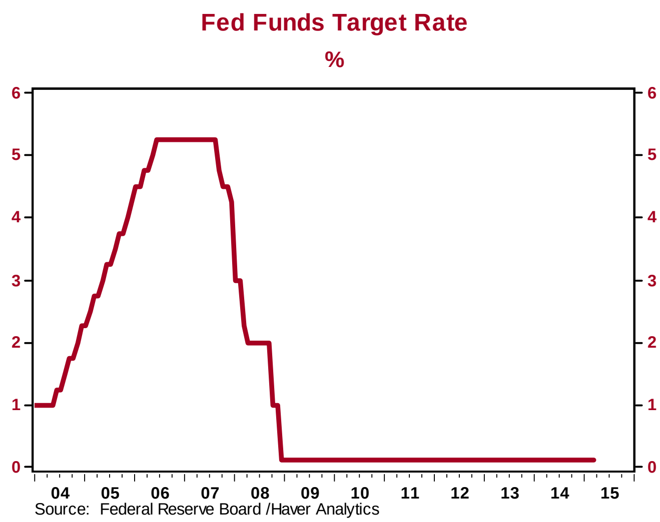
Yellen Loses "Patience," But Maintains Flexibility

The Federal Reserve is no longer committed to being "patient" before it starts raising rates. In Fed-speak, that means it will actively consider raising rates starting in two meetings, which will be in mid-June.

However, a June rate hike is not a fait accompli. Fed Chief Yellen appears to have bent over backward to make sure the Fed's doves don't feel like they're being railroaded into supporting a rate hike at that meeting.



For example, the Fed reduced its projection for the unemployment rate over the long run to about 5.1%, which is about 0.25 percentage points below what it projected only three months ago. That change is important because the Fed's economic models say a lower unemployment rate relative to the long-run average translates into higher inflation. So, by cutting the long-term average, the unemployment rate can go lower before the Fed's models signal higher inflation.

In addition, there were some notable changes to the "dot matrix" showing where Fed policymakers think interest rates will go over the next few years. Back in December, the dots showed the median policymaker at the Fed thought short-term rates would rise 100 basis points this year and 125 – 150 bp in 2016. Now the median dots suggest rate hikes of only 50 bp this year and 125 bp next year.

Yellen herself appears to have participated in the downgrade of rate-hike expectations. There are 17 participants at the meeting and she is probably on the dovish side. So, with the highest dot being the most hawkish, we're guessing Yellen is probably around dot number 12. Back in December, that dot suggested an increase of 75 bp this year and 125 bp next year. Now that same dot suggests 50 bp this year and 100 bp next year.

However, we would not read too much into these changes. Yellen is going to great lengths to make sure the extreme doves at the Fed – the ones who would prefer to go *all year* without a rate hike – feel like they're being heard. Recent data on retail sales, manufacturing output, and home building have all been weak, so the Fed has room to recognize a moderation in the pace of economic growth. Our models suggest real GDP growth is tracking an annualized pace of 1% in Q1 and we bet the Fed's models are showing something similar. But, like last year, we expect the pace of growth to bounce back rapidly by mid-year.

Ultimately, the Fed's statement today was about being dependent on the data. We suspect Yellen understands a pick-up in growth is likely, just like last year, and by that time she will have the chance to alter her forecast, as will the others at the Fed. And, having recognized recent weakness at today's meeting, she'll have a better chance to get the more extreme doves to acknowledge a re-acceleration in growth by June.

The bottom line is that, although we're not quite as confident as we previously were, we still think the Fed is on track to start raising rates in June. Nominal GDP – real GDP growth plus inflation – is up 3.6% in the past year and up at a 4.1% 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.

Either way, once the Fed eventually raises rates, it's unlikely to raise rates at every meeting, as was done in the past two prolonged rate hike cycles under Alan Greenspan in the late 1990s and Ben Bernanke in the middle of the prior decade. Instead, the Fed will probably raise rates at every other meeting for the first year, before embarking on a more aggressive path in the second half of 2016 and beyond.

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 January suggests that economic growth has moderated somewhat. Labor market conditions have improved further, with strong job gains and a lower unemployment rate. A range of labor market indicators suggests that underutilization of labor resources continues to diminish. Household spending is rising moderately; declines in energy prices have boosted household purchasing power. Business fixed investment is advancing, while the recovery in the housing sector remains slow and export growth has weakened. Inflation has declined further below the Committee's longer-run objective, largely reflecting declines in energy prices. Market-based measures of inflation compensation remain low; 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. 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 energy price declines and other factors 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 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 and international developments. Consistent with its previous statement, the Committee judges that an increase in the target range for the federal funds rate remains unlikely at the April FOMC meeting. The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term. This change in the forward guidance does not indicate that the Committee has decided on the timing of the initial increase in the target range.

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; Jeffrey M. Lacker; Dennis P. Lockhart; Jerome H. Powell; Daniel K. Tarullo; and John C. Williams..