First Trust
Monday Morning OUTLOOK
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Fed Will Kick The Can, But Shouldn't

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

Wednesday – the day people have been talking about for months – is fast approaching. The Federal Reserve will announce its policy decision on Wednesday and futures markets don't expect any change. Nonetheless, that's a forecast of what the Fed will do, not what it should do. We think the US economy is long past the point where short-term interest rates should be held at zero.

Nominal GDP – real GDP growth plus inflation – has grown at a 3.5% to 4% annual rate for the past five years. That suggests a "neutral" monetary policy, one consistent with a stable general price level, would put the federal funds rate somewhere north of 3%.

Some analysts have made the case that monetary policy *shouldn't* be neutral right now, that it should still be expansionary, because the economy hasn't fully recovered from the last recession. But the unemployment rate is now 5.5%, with job openings (demand for labor) at a 15-year high with weak growth in labor supply. Moreover, even a 1% federal funds rate would leave monetary policy expansionary.

Some analysts also say the Fed should hold off on lifting rates until the inflation rate is at or clearly moving toward the Fed's 2% goal. But, in the past year, energy prices have fallen 19% (according to the consumer price index). This is not likely to happen again and the CPI ex-energy is up 1.8% in the past twelve months. Meanwhile, rents continue to gradually accelerate. So if energy prices rise modestly in the year ahead and rents continue on their trend, we could easily see headline inflation at or above 2% in the year ahead.

Nonetheless, the market consensus puts odds of a rate hike this Wednesday at slim to none. The reason this is important is that Janet Yellen's Fed is not going to pull a major surprise on the financial markets, particularly about the timing of the first rate hike in nine years. So, if the Fed really intended to raise rates on Wednesday they would have used very obvious leaks to key journalists and very public speeches to prepare the markets. Get ready for some can kicking.

Part of the problem with market expectations is that temporary factors (weather, port strikes, etc.) held down reported real GDP growth in the first quarter. Add to this seasonal adjustment problems with GDP, which have artificially held down first quarter growth for 20-years, and it's no wonder people thought the economy was in trouble.

But, recent data have suggested that Q1 wasn't as bad as previously reported and the government is working on a fix to its data problems. When all is said and done, we expect Q1 GDP to show positive growth and then second quarter GDP to come in around a 3% growth rate.

If the market had these numbers originally, a Fed rate hike in June would have been considered more likely. But, more importantly, they will make a rate hike by, or maybe before September, highly likely.

Two things are important about this. First, it doesn't really matter whether the Fed raises rates in June or September, rates are headed higher. And second, the later the Fed waits, the higher short-term rates will need to peak later in the cycle. Right now, the Fed consensus says that short-term rates should be near 3.75% on a long-run average (which is consistent with our GDP model). But, if the Fed waits too long, inflation becomes more of a problem and that rate can move up.

The good news is that any rate hikes in the next 12 months will not remotely come close to derailing the economy. The Fed will just be "less loose," not "tight."

In the meantime, we are left with a Plow Horse economy, marked by stellar innovation and entrepreneurship but weighed down by the burdens of government over-spending, over-taxing, and over-regulation. Keep all of this in mind when you hear the news on Wednesday that the Fed deferred action on higher rates.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-15 / 7:30 am	Empire State Mfg Survey – Jun	6.0	**5.0**	-2.0	3.1
8:15 am	Industrial Production – May	+0.2%	**+0.2%**	-0.2%	-0.3%
8:15 am	Capacity Utilization – May	78.3%	**78.2%**	78.1%	78.2%
6-16 / 7:30 am	Housing Starts – May	1.091 Mil	**1.065 Mil**		1.135 Mil
6-18 / 7:30 am	Initial Claims – June 13	277K	**279K**		279K
7:30 am	CPI – May	+0.5%	**+0.5%**		+0.1%
7:30 am	"Core" CPI – May	+0.2%	**+0.2%**		+0.3%
9:00 am	Leading Indicators – May	+0.4%	**+0.4%**		+0.7%
9:00 am	Philly Fed Survey – Jun	8.0	**9.3**		6.7

Consensus forecasts come from Bloomberg. 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.