First Trust
ECONOMIC RESEARCH REPORT
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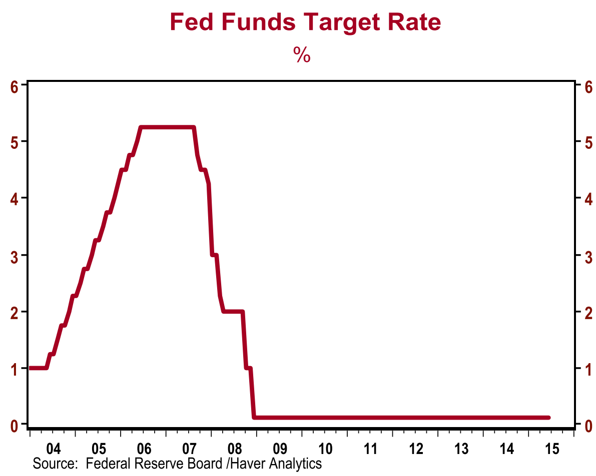
June 17, 2015 • 630.517.7756 • www.ftportfolios.com

Fed Talks Hawkish, Acts Dovish

Three major takeaways from today's statement and projections from the Federal Reserve:

First, the Fed upgraded its assessment of the current state of the economy, lifting its general appraisal of the labor market, housing and consumer spending.

Second, the Fed downgraded its assessment of real GDP growth in 2015, to about 1.9% from a prior estimate in March of about 2.5%. We think this is an overreaction to weakness in Q1, which was due a combination of temporary factors (bad weather, port strikes, and oil price declines) as well as the government's poor job of seasonally-adjusting the data. The same thing happened last year, when the economy contracted in Q1, the Fed downgraded its forecast in June and then the economy ended up beating that forecast.



Third, consistent with the downgrade of projected economic growth in 2015, the Fed's "dot matrix" showing where policymakers think interest rates will go over the next few years shows a shallower glide path for rate hikes. Back in March, the dots showed the median policymaker at the Fed thought short-term rates would rise 50 basis points this year and 125 bp in 2016. Now the median dots suggest 50 bp this year but only 100 next year.

All of this adds up to the likelihood that the Fed will start hiking short-term rates in September, although a rate hike in either late July (the very next meeting) or even October shouldn't be casually dismissed.

Why September? One reason is that the Fed's dot matrix strongly hints at two rate hikes this year and then a pattern of moving every other meeting in 2016. That would be consistent with raising in September and December this year, while taking a breather in October/November which would give Fed Chief Janet Yellen the chance to explain the rate hikes at a regularly scheduled press conference.

Another reason is that the September meeting will be the first time the Fed will have the government's annually revised figures on real GDP growth for the first quarter plus the initial glimpse of growth in Q2, which should be much better than Q1, just like last year. Given our forecast of much better news in that report, it's hard to see the Fed waiting beyond September to start raising rates.

We believe the Fed should have raised rates today; the economy can handle it. 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 say 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 and tepid growth in labor supply. Moreover, even a 1% federal funds rate would leave monetary policy expansionary.

Meanwhile, the CPI ex-energy is up 1.8% in the past twelve months and energy prices are more likely to be up in the next twelve months rather than down. In other words, we may get to the 2% inflation target much faster than the Fed now anticipates.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in April suggests that economic activity has been expanding moderately after having changed little during the first quarter. The pace of job gains picked up while the unemployment rate remained steady. On balance, a range of labor market indicators suggests that underutilization of labor resources diminished somewhat. Growth in household spending has been moderate and the *housing sector has shown some improvement; however, business fixed investment and net exports stayed soft. Inflation continued to run below the Committee's longer-run objective, partly reflecting earlier declines in energy prices and decreasing prices of non-energy imports; energy prices appear to have stabilized. 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 earlier 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 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. 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.

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.

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