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ECONOMIC RESEARCH REPORT
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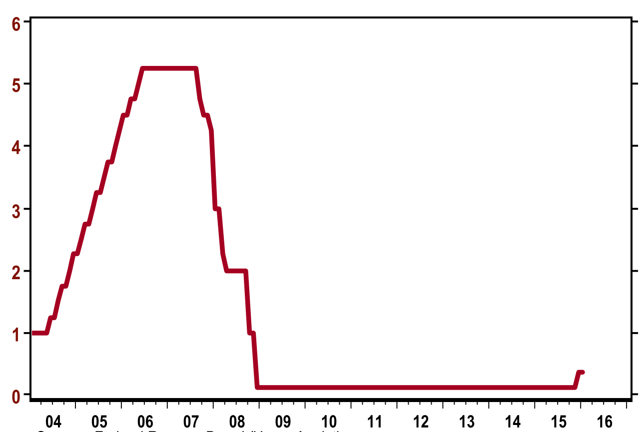
Fed Waiting for More Information

After starting liftoff in December, no one really expected much out of today's Fed meeting. And the Fed delivered exactly that, voting unanimously to do…nothing. But despite no action, their wording will get plenty of scrutiny.

The major issue going into today's meeting was whether the Federal Reserve would hint that it was no longer on track to raise rates by a total of one percentage point this year – most likely, in four rate hikes of 25 basis points each – like it suggested in the policy assessment back in December. That path would presumably be implemented by one 25 bp rate hike at the second meeting in each calendar quarter – March, June, September, and December – which coincides with the quarterly Fed press conferences.



Source: Federal Reserve Board /Haver Analytics

On that score, the Fed removed language from December that it sees "the risks to the outlook for both economic activity and the labor market as balanced." It also added language that it "is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook." This resembles the language temporarily added back in September that it was "monitoring developments abroad." The new language is significant because it was in September when many anticipated a rate hike that didn't materialize; the Fed delayed the rate hike until December due to temporary financial market turmoil.

Some analysts might therefore take today's language as a sign the Fed will delay a rate hike beyond the next meeting in March. But we think the Fed has yet to make that decision and a March rate hike is still more likely than not.

First, recent financial market turmoil is unlikely to linger for the next seven weeks, which would take us to the March meeting. Second, the Fed lifted its assessment of the labor market, saying job gains are "strong," rather than "ongoing." Third, although the Fed acknowledged slower economic growth in late 2015, it elsewhere mentioned slower inventories, which only have a temporary influence on growth.

Although the Fed noted a reduction in market-based measures of inflation compensation, it also maintained its view that inflation will rise to 2% over the medium term.

At present, the federal funds futures market anticipates only one rate hike this year. One! We think rate hikes are much more likely to come in closer to what the Fed projected back in December. In turn, this means interest rates across the yield curve should rise a bit faster and further than the market now expects.

The economy can handle higher short-term rates. The unemployment rate is already very close to the Fed's long-term projection of 4.9% and nominal GDP growth – real GDP growth plus inflation – is up at a 3.9% annual rate in the past two years.

Moreover, we are starting to see early signs of accelerating wage inflation. Average hourly earnings rose 2.5% in 2015 versus 1.8% in 2014 and 1.9% in 2013. That might not seem like much, but it's quite generous in an economy where consumer prices rose only 0.7% last year (due to falling energy prices) and where rising fringe benefit costs, like health care, aren't even included in the measure of wages.

After today, look for Fed speakers to highlight "data dependence" over the next few weeks as it gathers information before it's next decision in March.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in December suggests that labor market conditions improved further even as economic growth slowed late last year. Household spending and business fixed investment have been increasing at moderate rates in recent months, and the housing sector has improved further; however, net exports have been soft and inventory investment slowed. A range of recent labor market indicators, including strong job gains, points to some additional decline in underutilization of labor resources. Inflation has continued to run below the Committee's 2 percent longer-run objective, *partly reflecting declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation declined further; survey-based measures of longer-term inflation expectations are little changed, on balance, in recent months.*

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market indicators will continue to strengthen. Inflation is expected to remain low in the near term, in part because of the further declines in energy prices, but to rise to 2 percent over the medium term as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further. The Committee is closely monitoring global economic and financial developments and is assessing their implications for the labor market and inflation, and for the balance of risks to the outlook.

Given the economic outlook, the Committee decided to maintain the target range for the federal funds rate at 1/4 to 1/2 percent. The stance of monetary policy remains accommodative, thereby supporting further improvement in labor market conditions and a return to 2 percent inflation.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to 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. In light of the current shortfall of inflation from 2 percent, the Committee will carefully monitor actual and expected progress toward its inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

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, and it anticipates doing so until normalization of the level of the federal funds rate is well under way. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; James Bullard; Stanley Fischer; Esther L. George; Loretta J. Mester; Jerome H. Powell; Eric Rosengren; and Daniel K. Tarullo.

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.