First Trust
ECONOMIC RESEARCH REPORT
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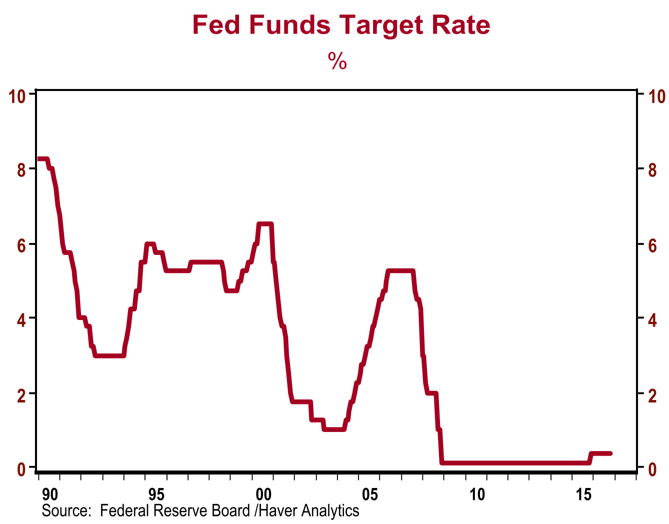
Rate Hike Looks Set for December

The Federal Reserve has laid the foundation for a December rate hike.

Nobody we know was seriously expecting the Fed to raise rates today, with the election in six days and without a press conference scheduled for Fed Chair Janet Yellen to explain her thinking. Nonetheless, changes to the wording of today's release were almost entirely hawkish, a signal to markets to be ready in December.



That said, there were two items in today's report that may be touted by the pouting pundits as signs that the Fed could hold off on a hike before year-end. First, the statement included a change about household spending from "growing strongly" to "rising modestly". Second, Boston Fed president Eric Rosengren voted to keep rates unchanged despite voting for a rate hike at September's meeting. But we chalk this up to his wanting to avoid a rate hike so close to the election, not to any change of heart regarding the strength of the economy.

Baring these two modestly dovish notes, all of the remaining changes to the Fed statement point hawkish. The Fed noted that "inflation has increased somewhat since earlier this year," while also highlighting that market-based measures of inflation have moved higher in recent months. In addition, previous comments about the downward pressure of energy prices on inflation were removed altogether. But possibly the most direct sign that the Fed plans to hike in December came with the addition of a single word; the Fed is now waiting for "some" further evidence of progress towards full employment and 2 percent inflation. This tiny tweak in language suggests that they are acknowledging the largely positive data releases since the September meeting, while also lowering the bar for what is needed between now and December 14th for them to pull the trigger.

The dot plots released after the September meeting showed the majority of FOMC participants projecting at least one rate hike in 2016, and speeches by Fed members since that meeting have reiterated the outlook that a rate hike looks appropriate given economic conditions. Baring a serious surprise to the downside in employment or inflation (and we don't expect either), it's hard to see the Fed delaying much further.

In our view, economic fundamentals warranted a rate hike at the start of the year, and the Fed would have been justified to raise rates today. The economy can handle higher short-term rates. The unemployment rate is already very close to the Fed's long-term projection of 4.8% and nominal GDP – real GDP growth plus inflation – has grown at a 3.0% annual rate in the past two years. Moreover, we are starting to see early signs of accelerating inflation. "Core" consumer prices are up 2.2% versus a year ago, tied with the largest increase since 2008, while average hourly earnings are up 2.6% from a year ago, despite many highly paid and productive Baby Boomers exiting the workforce.

Slightly higher short-term rates are not going to derail US growth, but will help avoid the misallocation of capital that's inevitable if short-term rates remain artificially low.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in September indicates that the labor market has continued to strengthen and growth of economic activity has picked up from the modest pace seen in the first half of this year. Although the unemployment rate is little changed in recent months, job gains have been solid. Household spending has been rising moderately but business fixed investment has remained soft. Inflation has increased somewhat since earlier this year but is still below the Committee's 2 percent longer-run objective, partly reflecting earlier declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation have moved up but remain low; most 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 expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market conditions will strengthen somewhat further. Inflation is expected to rise to 2 percent over the medium term as the transitory effects of past declines in energy and import prices dissipate and the labor market strengthens further. Near-term risks to the economic outlook appear roughly balanced. The Committee continues to closely monitor inflation indicators and global economic and financial developments.

Against this backdrop, the Committee decided to maintain the target range for the federal funds rate at 1/4 to 1/2 percent. The Committee judges that the case for an increase in the federal funds rate has continued to strengthen but decided, for the time being, to wait for some further evidence of continued progress toward its objectives. 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; Jerome H. Powell; Eric Rosengren; and Daniel K. Tarullo. Voting against the action were: Esther L. George and Loretta J. Mester, each of whom preferred at this meeting to raise the target range for the federal funds rate to 1/2 to 3/4 percent.