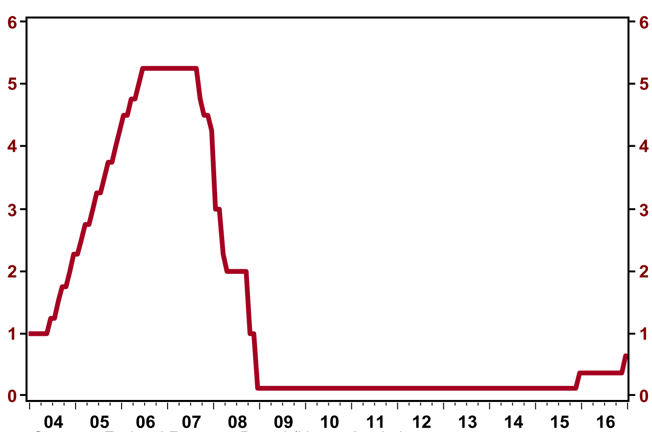
First Trust
ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Economist*
December 14, 2016 • 630.517.7756 • www.ftportfolios.com

The Fed Turns Hawkish

The Federal Reserve unanimously decided to raise rates in 2016 – finally! – by a quarter of a percentage point earlier today, as the markets expected. The federal funds rate is now set to hover between 0.50% and 0.75%.

In addition, the Fed slightly accelerated the pace of projected rate hikes in 2017, up to a median forecast of three hikes next year versus a prior estimate of two. After that, there was no change in the projected pace of rate hikes, with the Fed still anticipating three rate hikes each in 2018 and 2019 and an ultimate long-run average rate of 3.0%.

Meanwhile, the Fed made its statement more hawkish. First, it said "inflation has increased" versus the last statement in November, which used a wishy-washy "inflation has increased *somewhat*." Second, it said market-based measures of inflation compensation "have moved up considerably." Other than that, there were no noteworthy changes to the statement.



Source: Federal Reserve Board /Haver Analytics

In our view, economic fundamentals warranted multiple rate hikes this year. The unemployment rate is already below the Fed's long-term projection of 4.8% and nominal GDP – real GDP growth plus inflation – has grown at a 3.1% annual rate in the past two years. Meanwhile, consumer price inflation has accelerated to 1.6% in the past year from 0.2% in the year ending in October 2015.

Given the likelihood of tax cuts next year, we think the Keynesians at the Fed will become increasingly comfortable with their projection of faster rate hikes, unlike in the past few years when they over-promised and under-delivered. Slightly higher short-term rates are not going to derail US growth. Instead, rate hikes will help prevent a misallocation of capital and problems down the road.

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 November indicates that the labor market has continued to strengthen and that economic activity has been expanding at a moderate pace since mid-year. Job gains have been solid in recent months and the unemployment rate has declined. Household spending has been rising moderately but business fixed investment has remained soft. Inflation has increased 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 considerably but still are 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.

In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 1/2 to 3/4 percent. The stance of monetary policy remains accommodative, thereby supporting some further strengthening 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..