First Trust
ECONOMIC RESEARCH REPORT
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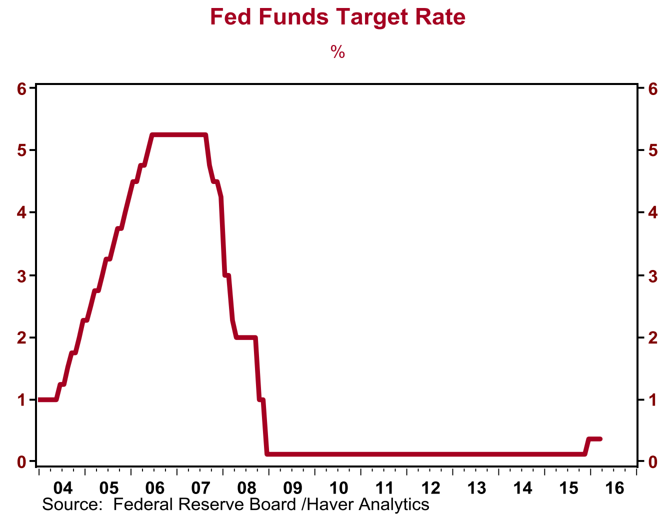
Rates Hikes on the Way

Mark your calendars for a rate hike on June 15. Although the Federal Reserve cut its estimate of the most likely path for interest rates this year, it still projected two rate hikes for later this year, which suggests one hike in June and then one at the end of the year after the election.

Today's statement was more hawkish than the last statement in late January and the one dissent, from Kansas City Fed Bank President Esther George, was in favor of hiking rates by 25 basis points at *today's* meeting.

What's different in the statement? First, the Fed said the economy is growing at a "moderate pace," which is better than the slowdown of late last year. Second, the Fed noted the recent pickup in inflation, which means it's focused on "core" measures of inflation, which exclude food and energy. Third, although the Fed said global developments can pose risks, it took out the reference to "closely monitoring" those developments.



Perhaps the most important change to the statement, which was reiterated by Fed Chief Yellen in her press conference, was that the US economy is growing moderately *"despite"* global developments. In other words, all the fear and turmoil earlier this year overestimated the damage it would cause to the US and the Fed is unlikely to put as much weight on negative foreign developments again. In addition, Yellen went out of the way at the press conference to mention potential *upside* risks from abroad as well as from the recent rebound in oil prices.

So why not raise rates at the next meeting on April 27? Why wait until June? In our view, economic fundamentals warrant a rate hike as soon as possible. However, today's Fed statement did not add any language suggesting a rate hike is imminent, like it added in October 2015 when it referred to the "next meeting" and then raised rates at the very next meeting in December 2015.

Compared to the Fed's projections back in December, today's outlook suggests two fewer rate hikes this year (50 basis points versus 100 bp), the same amount of rate hikes in 2017 (100 bp) and one additional rate hike in 2018 (100-125 bp versus 75-100 bp). It also looks like the Fed still expects the end of the rate hike cycle to come in early 2019, with a peak rate of 3.25% (versus a prior estimate of 3.5%).

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 growth – real GDP growth plus inflation – is up at a 3.5% annual rate in the past two years. Moreover, we are starting to see early signs of accelerating inflation. "Core" consumer prices are up 2.3% versus a year ago, the largest increase since 2008.

Slightly higher short-term interest rates are not going to derail the US expansion, 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 January suggests that economic activity has been expanding at a moderate pace despite the global economic and financial developments of recent months. Household spending has been increasing at a moderate rate, and the housing sector has improved further; however, business fixed investment and net exports have been soft. A range of recent indicators, including strong job gains, points to additional strengthening of the labor market. Inflation picked up in recent months; however, it 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 remain low; 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. However, global economic and *financial developments continue to pose risks. Inflation is expected to remain low in the near term, in part because of earlier 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 continues to monitor inflation developments closely.*

Against this backdrop, 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; Loretta J. Mester; Jerome H. Powell; Eric Rosengren; and Daniel K. Tarullo. Voting against the action was Esther L. George, who preferred at this meeting to raise the target range for the federal funds rate to 1/2 to 3/4 percent.