First Trust
ECONOMIC RESEARCH REPORT
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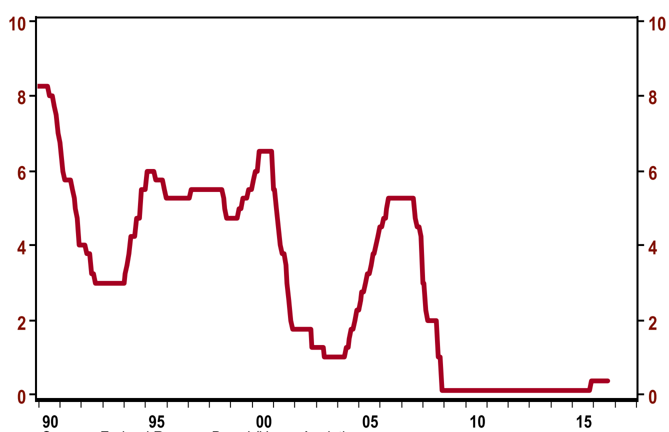
Rate Hike Looks Set for December

The Federal Reserve kicked the rate hike can down the road once again, but looks very likely to raise rates in December.

The biggest news today wasn't the Fed's unwillingness to raise rates; if the Fed has been seriously considering a rate hike they would have made that clear to investors in the past few weeks. Instead, today's biggest news was that three members dissented from the (lack of) policy action, all preferring a quarter-percentage point rate hike at today's meeting.

Fed Funds Target Rate
%



Source: Federal Reserve Board /Haver Analytics

How can we be confident about a December rate hike given how often the Fed has punted on rate hikes so far this year? Because the new dot plot released today from the Fed shows that, with only two meetings left this year, fourteen of seventeen policymakers think rates will rise by at least 25 basis points by the end of 2016, with only three thinking rates will finish 2016 without any rate hike at all. In addition, Fed Chief Yellen said at her post-meeting press conference that "most" policymakers (you can bet this group included her!) already think the time is appropriate for a rate hike, but that it wouldn't hurt to wait a little while before doing so.

Another way to think of it is that the three who dissented today will likely dissent in November as well, and then the Fed will swap dissenters in December, with the three who want to wait until at least next year for any rate hikes, finally finding themselves on the losing end of the policy decision.

So if the Fed is ready to raise rates, why not do it at the next meeting in November? Because it's only six days before the election and we think the Fed would prefer to stay out of the limelight so close to Election Day.

Other notable shifts by the Fed in its policy statement include:
(1) Recognizing a pick up in the growth of the economy,
(2) Saying the near-term risks to the outlook are "roughly balanced," rather than a "diminished" risk of downside developments, and
(3) Adding that the case for rate hikes has strengthened.

The Fed also made slight downward revisions to its projection for real GDP growth, both this year and for the long-term average. As a result, the projection for the long-term average annual growth rate for nominal GDP (real GDP growth plus inflation) is now 3.8%.

In terms of the pace of rate hikes, the median projection from policymakers is only two rate hikes in 2017. With the long-term average remaining at 3.00%, that means more rate hikes in 2019-20, instead.

In our view, economic fundamentals warranted a rate hike at the start of the year, and even more so 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 3.3% 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, tied with the largest increase since 2008. Average hourly earnings are up 2.4% 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 July 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, on average. Household spending has been growing strongly but business fixed investment has remained soft. Inflation has continued to run 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 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 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 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 strengthened but decided, for the time being, to wait for 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; and Daniel K. Tarullo. Voting against the action were: Esther L. George, Loretta J. Mester, and Eric Rosengren, each of whom preferred at this meeting to raise the target range for the federal funds rate to 1/2 to 3/4 percent.