First Trust
ECONOMIC RESEARCH REPORT
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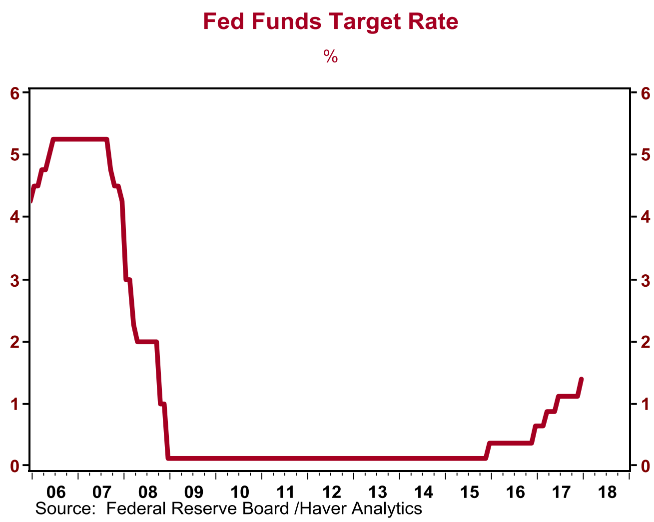
Fed Stays on Right Hiking Path

The Federal Reserve did what just about everyone expected earlier today and raised short-term interest rates by 0.25 percentage points. The federal funds rate is now in a range from 1.25 - 1.50% and the Fed is now paying banks 1.50% on their reserve balances.

Today's move was the third 25 basis point rate hike in 2017, matching the Fed's median projection for rate hikes that it made a year ago. At present, the Fed's "dot plot," which it releases at the last meeting of every calendar quarter, projects another three rate hikes in 2018. That would bring the funds rate to a range of 2.00% to 2.25% and the rate on reserves to 2.25%. The Fed did not change its forecast for another two or three rate hikes in 2019, but suggested a chance of a slightly higher peak for the funds rate in 2020. Regardless, the median Fed policymaker has the long-run funds rate at 2.75%.



Despite the lack of change in the projected path of interest rates, there were some noticeable changes to the outlook for the economy in the near term. In particular, the Fed now expects 2.5% economic growth in 2018 (Q4/Q4) versus a prior estimate of 2.1% and expects growth to be slightly stronger than previously estimated in 2019-20 as well.

Meanwhile, the Fed projects a lower bottom for the unemployment rate in 2018-19: 3.9% versus 4.1%. Oddly, the reason for the lower bottom is not the faster economic growth over the next few years but simply because, at 4.1%, the jobless rate is already lower than the 4.3% the Fed thought it would get to this year. Another way to think about it is that the Fed is still forecasting a 0.2 percentage point drop in the jobless rate in 2018 and no change in 2019, the same as it was forecasting back in September.

The only way we can square faster growth with no change in the drop in unemployment is that the Fed anticipates faster productivity growth in the next few years. We think that makes sense given that the tax cut now winding its way through Congress should enhance supply incentives and boost capital investment.

Where we differ with the Fed's forecast is that we expect growth to be around 3% per year in 2018-19 and the jobless rate to dip even further below the Fed's longer-run projection of 4.6%. Look for the jobless rate to finish next year at 3.7%, the lowest since the late 1960s. Look for it to finish 2019 at about 3.3%, which would be the lowest since the early 1950s.

In turn, we think investors should see the Fed's current projected path of interest rates as a floor for rate hikes in the next few years. That's a big difference from the current market consensus that foresees two rate hikes in 2018. Note that at the press conference, Fed Chief Yellen said "most" Fed policymakers had included the probability of tax cuts into their forecasts. This leaves some room for more upside as the tax cuts are likely to be enacted very soon.

The Fed's statement itself didn't have any significant changes versus the statement from November. However, it revealed that two Fed bank presidents dissented from raising rates today: Chicago's Charles Evans and Minneapolis's Neel Kashkari. Look for similar dissents early next year, but we think those will disappear by late 2018 as the case for rate hikes gets clearer.

In the meantime, the Fed will keep reducing its balance sheet at a pace of up to $10 billion per month for the fourth quarter, increasing that to $20 billion monthly pace in the first quarter of 2018, $30 billion in Q2, $40 billion in Q3, and $50 billion in Q4. After that, the Fed is projecting it would maintain that $50 billion monthly pace until it's satisfied with the size of the balance sheet. (For the foreseeable future, the balance sheet cuts would be 60% in Treasury securities and 40% in mortgage-related securities.)

The bottom line, in our view, is that monetary policy remains too loose and the economy can handle higher short-term rates. Nominal GDP (real GDP growth plus inflation) is up 3.5% per year in the past two years, leaving plenty of room for more rate hikes in 2018-19.

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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 rising at a solid rate. Averaging through hurricane-related fluctuations, job gains have been solid, and the unemployment rate declined further. Household spending has been expanding at a moderate rate, and growth in business fixed investment has picked up in recent quarters. On a 12-month basis, both overall inflation and inflation for items other than food and energy have declined this year and are running below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Hurricane-related disruptions and rebuilding have affected economic activity, employment, and inflation in recent months but have not materially altered the outlook for the national economy. Consequently, the Committee continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market conditions will remain strong. Inflation on a 12‐month basis is expected to remain somewhat below 2 percent in the near term but to stabilize around the Committee's 2 percent objective over the medium term. Near-term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely.

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 1-1/4 to 1‐1/2 percent. The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained 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. The Committee will carefully monitor actual and expected inflation developments relative to its symmetric inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant 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.

Voting for the FOMC monetary policy action were Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Patrick Harker; Robert S. Kaplan; Jerome H. Powell; and Randal K. Quarles. Voting against the action were Charles L. Evans and Neel Kashkari, who preferred at this meeting to maintain the existing target range for the federal funds rate.