First Trust
ECONOMIC RESEARCH REPORT

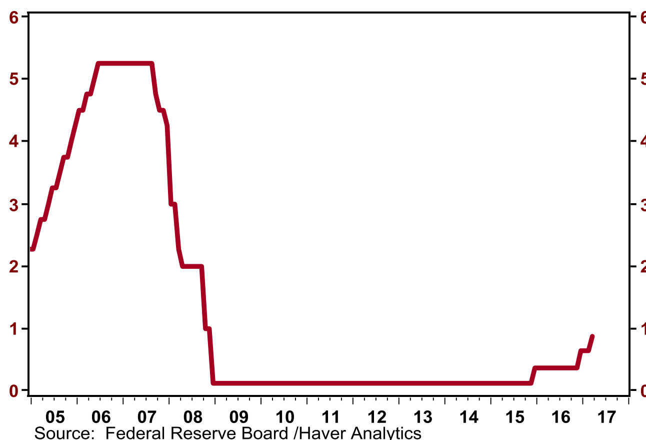
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Economist*

March 15, 2017 • 630.517.7756 • www.ftportfolios.com

A Dovish Rate Hike

Considering that the Federal Reserve raised short-term interest rates by a quarter point, today's Fed statement was surprisingly dovish.

The dovish elements include:
(1) adding language on "core' inflation (which excludes food and energy prices) running at less than 2%,
(2) characterizing its inflation goal as "symmetric," which means inflation can run above 2% as long as the Fed doesn't think the overshoot will be persistent, and
(3) a dissent in favor of keeping rates unchanged at today's meeting



In addition, while some analysts thought the Fed might increase the pace of projected rate hikes in 2017 and beyond, the Fed left those projections essentially unchanged, with median expectation of three 25 basis point rate hikes in each of 2017 and 2018. In particular, five of the seventeen Fed decision-makers think there should be four or more rate hikes this year, no different than back in December.

The lack of change in the "dot plot" describing short-term rate projections was underscored by almost no change in the economic forecasts for real GDP growth, unemployment, or inflation.

However, the statement wasn't all dovish. After all, the Fed did raise the range for short-term rates by 25 basis points to 0.75% - 1.00%. The Fed also noted a firming in business investment and that its favorite measure of inflation (the PCE price index) was close to the goal of 2%.

From a long-term policy standpoint, we're disappointed by today's statement. We'd like to see the Fed maintain inflation in the 0% to 2% range. By contrast, today's statement reiterates that the Fed is more comfortable with a range *centered* on 2%, meaning it doesn't have to hasten the pace of rate hikes later this year if PCE inflation hits 2.5%-plus, so long as the Fed's economic projections show it eventually coming back down to 2%. We think that risks a mistake that could lead to much faster rate hikes later on if inflation runs above Fed forecasts.

We still expect the Fed to raise rates three times total in 2017, with the odds of a fourth rate hike more likely than the Fed stopping at two. Economic fundamentals suggest the Fed is already behind the curve and the economy can handle a faster pace of rate hikes. Employment gains remains healthy and nominal GDP – real GDP growth plus inflation – has grown at a 3.2% annual rate in the past two years. Moreover, we are seeing signs of accelerating inflation, with the Fed's favorite measure poised to hit 2.1% when February data arrive at the end of the month.

The bottom line is that the Fed took a big step in the right direction earlier today. Unfortunately, the Fed's language suggests it probably won't take as many of these steps as it should before the year is through.

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 February indicates that the labor market has continued to strengthen and that economic activity has continued to expand at a moderate pace. Job gains remained solid and the unemployment rate was little changed in recent months. Household spending has continued to rise moderately while business fixed investment appears to have firmed somewhat. Inflation has increased in recent quarters, moving close to the Committee's 2 percent longer-run objective; excluding energy and food prices, inflation was little changed and continued to run somewhat 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. The Committee expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen

somewhat further, and inflation will stabilize around 2 percent over the medium term. 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 3/4 to 1 percent. The stance of monetary policy remains accommodative, thereby supporting some further strengthening in 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.

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; Charles L. Evans; Stanley Fischer; Patrick Harker; Robert S. Kaplan; Jerome H. Powell; and Daniel K. Tarullo. Voting against the action was Neel Kashkari, who preferred at this meeting to maintain the existing target range for the federal funds rate.

This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.