First Trust
Monday Morning OUTLOOK
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Watch Reserves, Not Rates

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

As Washington DC melts down, entrepreneurs keep moving, people keep working and spending; the economy keeps growing. The Federal Reserve keeps meeting and speaking, too, but now it appears they will actually act.

Next week's Fed meeting (March 15th) is going to be major news one way or another. Most analysts lean our way and now think the Fed will raise short-term interest rates by a quarter percentage point (25 basis points). We laid out the case two weeks ago (Time for a Rate Hike). If the Fed does raise rates, it will be just the third rate hike in over a decade, but the second since December, signaling new urgency to normalize.

However, if the Fed surprises and declines to raise rates, despite all the hints from recent Fed speakers including Fed Chief Yellen herself, it will also be major news, suggesting the Fed has an unfortunate bias against raising rates under pretty much any reasonable conditions. We don't think that's likely, but it would be big news.

Either way, investors need to focus on more than just interest rates. Rate hikes under the current monetary regime are different than any other time in history. In the past, when the Fed wanted the federal funds rate higher, it would shrink the amount of reserves in the banking system by selling bonds to banks and subtracting cash. With a smaller supply of reserves, banks would bid up their cost.

But these days, there are roughly $2 trillion in excess reserves and the Fed has no plans in motion to reduce them. As a result, a rate hike next week would push what the Fed pays banks on those excess reserves to 1% from 0.75%. The idea is that if the Fed pays higher rates, banks will continue to hold reserves and money supply growth and inflation can be contained.

This experiment has never been tried before and no one knows if it will work. In fact, there is good reason to believe it won't. An upward sloping yield curve suggests banks have more incentive to loan as rates rise, not less.

In other words, we will be watching the Fed's statement for two things. First, how quickly we can expect interest rates to rise in the year ahead, but also whether there are any plans to shrink the size of the balance sheet.

Don't blink. Things are changing rapidly. Just nine weeks ago, the market consensus was a 31% chance of a mid-March rate hike and only two hikes for the year. At Friday's close, the March rate hike odds were 94% and that would be the first of three rate hikes in 2017.

As these expectations changed, 10-year rates have barely budged, closing Friday at 2.49% versus 2.45% at the end of December. One possible reason for such a small change in the yield is that as long as investors think the cycle peak for short-term rates hasn't changed, then the average short-term rate over the next ten years hasn't changed much during the past few months. So there was no reason for long-term yields to change much, either.

The problem with this theory is that equities are moving like investors expect faster economic growth than the Plow Horse pace since mid-2009. In a faster growth environment, the peak for short-term rates should be higher, too.

We think bond investors will eventually come to this conclusion as well. With nominal GDP growing near 3 ½% in the past year and likely to accelerate, the level of interest rates should rise toward that level as well. And, even though we do not believe the size of the Fed's balance sheet affects long-term interest rates, the market behaves differently. So, as the Fed signals a faster pace of rate hikes and begins to whisper about allowing its bond holdings (and therefore excess reserves) to shrink, bond yields are likely to head higher.

The bottom line is that a hike in short-rates may not instantly set off higher long-term rates, but higher long-term rates are headed our way anyhow. It's just a matter of time.

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Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-6 / 9:00 am	Factory Orders – Jan	+1.0%	**+0.9%**	+1.2%	+1.3%
3-7 / 7:30 am	Int'l Trade Balance – Jan	-$48.5 Bil	**-$47.4 Bil**		-$44.3 Bil
2:00 pm	Consumer Credit– Jan	$17.8 Bil	**$16.9 Bil**		$14.2 Bil
3-8 / 7:30 am	Q4 Non-Farm Productivity	+1.5%	**+1.7%**		+1.3%
7:30 am	Q4 Unit Labor Costs	+1.6%	**+1.4%**		+1.7%
3-9 / 7:30 am	Initial Claims – Mar 4	238K	**234K**		223K
7:30 am	Import Prices – Feb	+0.1%	**+0.2%**		+0.4%
7:30 am	Export Prices – Feb	+0.1%	**+0.2%**		+0.1%
3-10 / 7:30 am	Non-Farm Payrolls – Feb	190K	**177K**		227K
7:30 am	Private Payrolls – Feb	190K	**181K**		237K
7:30 am	Manufacturing Payrolls – Feb	8K	**9K**		5K
7:30 am	Unemployment Rate – Feb	4.7%	**4.8%**		4.8%
7:30 am	Average Hourly Earnings – Feb	+0.3%	**+0.2%**		+0.1%

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