First Trust
ECONOMIC RESEARCH REPORT

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

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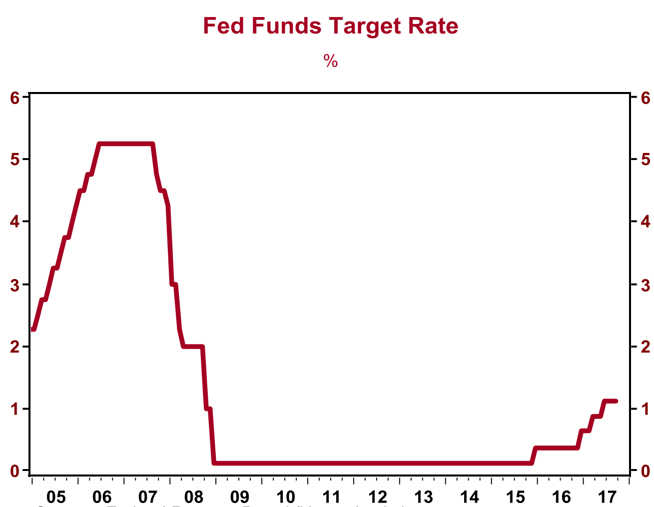
Fed Resists the Doves

The big news today wasn't the Federal Reserve's decision to start gradually reducing its balance sheet in October. Almost everyone expected that. Instead, the big news was that twelve of the sixteen members of the Fed's interest-rate setting body – the Federal Open Market Committee – think the Fed will be raising interest rates by at least 25 basis points later this year.

As recently as two weeks ago, the futures market in federal funds was generating about a 20% chance of another rate hike this year. Earlier today, before the Fed's statement, the odds were roughly 50%. Now the odds are in the 60-65% range. We think those odds are likely to rise even further in the months leading up to the December meeting.



Source: Federal Reserve Board /Haver Analytics

In the meantime, the Fed will be 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. This is no different than what the Fed said it would do three months ago at the meeting in June. (For the foreseeable future, the balance sheet cuts would be 60% in Treasury securities and 40% in mortgage-related securities.)

The Fed made some other changes to its "dot plot," but not in the near-term. The dot plot still suggests three rate hikes in 2018. However, back in June the median Fed path suggested three rate hikes in 2019, maybe four; now the Fed is torn between two or three rate hikes in 2019. In addition, back in June the median Fed path suggested a long-term average funds rate of 3.00%; now it's 2.75%.

In terms of the Fed's economic outlook, there were barely any changes. The Fed expects a little more real economic growth this year and a little less inflation, leaving nominal GDP growth (real GDP growth plus inflation) unchanged. The Fed's statement was a little more bullish on business investment and made it clear it wasn't worried about the medium-term economic effects of Hurricanes Harvey and Irma.

Notably, there were no dissents from today's statement, not even Minneapolis President Neel Kashkari, who made a dovish dissent two meetings ago back in June.

Although some may still fear the effects of the Fed renormalizing its balance sheet, we think the Fed should have started this process a long time ago and could even speed it up faster without hurting the economy. Could long-term interest rates go up? Sure they could! But they *should* have been higher already given economic fundamentals. While others fret about renormalization and rising rates damaging the economy or financial markets, investors should remain bullish. Look for faster economic growth and a continuation of the bull market in equities in the years ahead.

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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 that economic activity has been rising moderately so far this year. Job gains have remained solid in recent months, and the unemployment rate has stayed low. 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, overall inflation and the measure excluding food and energy prices 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. Hurricanes Harvey, Irma, and Maria have devastated many communities, inflicting severe hardship. Storm-related disruptions and rebuilding will affect economic activity in the *near term, but past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term. 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 strengthen somewhat further. Higher prices for gasoline and some other items in the aftermath of the hurricanes will likely boost inflation temporarily; apart from that effect, 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 maintain the target range for the federal funds rate at 1 to 1-1/4 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.

In October, the Committee will initiate the balance sheet normalization program described in the June 2017 Addendum to the Committee's Policy Normalization Principles and Plans.

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; Neel Kashkari; and Jerome H. Powell.