First Trust ECONOMIC RESEARCH REPORT

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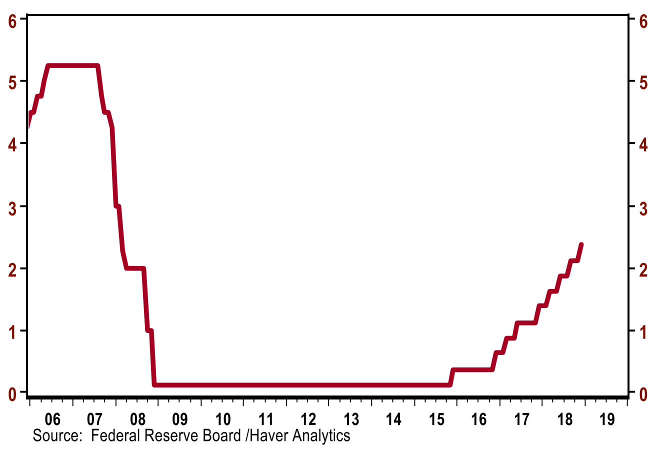
Market Overreacts to A More Dovish Fed

Today's much anticipated Fed meeting brought answers and new questions. As expected, the Fed raised rates 25 basis points to a range of 2-1/4 to 2 1/2 percent, marking a fourth rate hike in 2018. At the same time, it will continue to reduce the size of the balance sheet up to $50 billion per month (comprised of $30 billion in Treasuries and $20 billion of agency and mortgage backed securities). Those decisions were expected. The wildcard heading into today was the Fed's expectations of the future. And that's where things get interesting.



Lets start with the economic projections, given the emphasis by the Fed on "data dependence." Forecasts for unemployment and inflation were little changed from September, on balance, but the Fed did reduce its forecast for real GDP growth in 2018 to 3.0% from 3.1%, and to 2.3% from 2.5% for 2019 (forecasts for 2020-2021 were unchanged). That said, the Fed had been steadily raising growth projections since the start of the year, and today's forecasts essentially bring us back to where things stood back in June.

It's surprising, then, to see the Fed lower its expectations for rates moving forward. While the Fed anticipated three rate hikes for 2019 when they met in September - and in June when their growth forecasts were very similar to today's - they are now forecasting two hikes (and shifted the expected rate in subsequent years, including the long-run estimate, lower by one hike as well). The data is little changed, but their reaction to the data shifted more dovish. That said, the distribution of FOMC participant forecasts suggest that, while two hikes is both the median and average forecast for next year, the odds we will ultimately see three hikes in 2019 outweighs the odds that we will only see just one.

We continue to believe monetary policy remains far from tight, and that economic activity, by itself, will warrant four hikes next year. Our measure of "neutral" monetary policy is when the federal funds rate is at the level of trend nominal GDP growth, minus about 50 basis points. Accepting the Fed's downgraded growth forecasts, they are still expecting nominal GDP to grow at a 4.5% annual rate this year and next. That means four rate hikes next year would still leave us below "neutral" (and we think the Fed is underestimating where GDP growth will ultimately come in).

So that raises the question, why did the Fed lower its rate hike outlook? We have two guesses. First, they know they can raise their forecasts and guidance if growth comes in above trend, and this is a conservative approach intended to ease market concerns that have been elevated of late as events like Brexit and tariff "wars" leave uncertainty on the table - this also jibes with the added text in the Fed statement that they "continue to monitor global economic and financial developments and assess their implications for the economic outlook." Guess two is that the Fed is wary about raising rates faster until they see more movement at the long end of the yield curve. If the federal funds rate begins to approach the yield on the 10-year Treasury (think within 40-50 basis points), we expect the Fed to take a pause. There are ways for the Fed to put upward pressure on yields, such as actively selling treasuries from their balance sheet, but Powell today reiterated that they don't anticipate moving off the "autopilot" glide path that they have the balance sheet reduction on.

At the end of the day, the Fed will continue to monitor a two-part test for rates hikes, asking first if the economic data justifies higher rates, and second if the yield curve will not invert. If the economy performs as we expect next year and if the 10-year yield rises to 3.4%, as well, the Fed should ultimately end up having room for at least two, and perhaps three, rate hikes in 2019.

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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 strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has remained low. Household spending has continued to grow strongly, while growth of business fixed investment has moderated from its rapid pace earlier in the year. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. Indicators 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 judges that some further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. The Committee judges that risks to the economic outlook are roughly balanced, but will continue to monitor global economic and financial developments and assess their implications for the economic outlook.

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 2-1/4 to 2-1/2 percent.

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 maximum employment objective and its symmetric 2 percent inflation objective. 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.

Voting for the FOMC monetary policy action were: Jerome H. Powell, Chairman; John C. Williams, Vice Chairman; Thomas I. Barkin; Raphael W. Bostic; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Mary C. Daly; Loretta J. Mester; and Randal K. Quarles.