First Trust
Monday Morning OUTLOOK

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The Powell Fed: A New Era

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In the history of the NCAA Basketball Tournament, a 16th seed has never, ever, beaten a one seed…until this year. But, on Friday, the University of Maryland, Baltimore County (UMBC) beat the University of Virginia – not just a number one seed, but the top ranked team in the USA.

We don't expect the unexpected, however, when the Federal Reserve finishes its regularly scheduled meeting on Wednesday. Based on the federal funds futures market, there is a 100% chance that the Fed will boost the federal funds rate by 25 basis points, to a new range of 1.5% to 1.75%.

The markets are even giving a roughly 20% chance that the Fed raises rates 50 basis points. That's better odds than UMBC had, but we suspect it's highly unlikely given that this is Jerome Powell's first meeting as Fed chief.

The rate hike itself is not worrisome. It's expected and, at 1.75%, the federal funds rate is still below inflation and the growth rate for nominal GDP. There are also still more than $2 trillion in excess bank reserves in the system. The Fed is a very long way from being tight.

Instead, investors should focus on how the Fed changes its forecast of what's in store for the economy and the likely path of short-term interest rates over the next few years.

Back in December, the last time the Fed released projections on interest rates and the economy, only some of the policymakers at the Fed had incorporated the tax cuts into their forecasts. Prior to the tax cut, the median forecast from Fed officials expected real GDP growth of 2.5% in 2018 and 2.1% in 2019. Now that the tax cut is law, we expect Fed forecasters to move those estimates noticeably higher, to near 3% growth for 2018 and 2019, which should lower unemployment forecasts.

In December, the median Fed forecast was that the jobless rate would reach 3.9% in the last quarter of 2018 and remain there in 2019 before heading back to 4.6% in following years.

We're forecasting the unemployment rate should get to 3.3% by the end of 2019, which would be the lowest since the early 1950s. Beyond 2019, it's even plausible the jobless rate goes below 3.0%, as long as we don't lurch into a trade war or back off tax cuts or deregulation.

We doubt the new Fed forecast gets that aggressive, but with the jobless rate already at 4.1%, faster economic growth should push Fed forecasts well below 3.9% in spite of faster labor force growth.

For the Fed, lower unemployment rates mean faster wage growth and higher inflation. This may force a change in the Fed's "dot plot," which puts a dot on each member's expected path of short-term interest rates.

Back in December, the dot plot showed a median forecast of 75 basis points in rate hikes this year – basically, three rate hikes of 25 bps each. Four Fed officials expected four or more rate hikes in 2018, while twelve expected three or fewer. This time, we expect the dots to show a much more even split between "three or fewer" and "four or more."

At present, the futures market is pricing in three rate hikes as the most likely path this year, with a 36% chance of a fourth rate hike (or more). Look for the market's odds of that fourth rate hike to go up by Wednesday afternoon, which means longer-term interest rates will also likely move higher.

In addition, the markets will be paying close attention to Jerome Powell's performance at his first Fed press conference. With journalists planning "gotcha" questions, some negative headlines could result. If so, and if equities drop, the smartest investors should treat it as yet another opportunity to buy.

Since 2008, the Fed has embarked on unprecedented monetary ease. Rather than boosting the actual money circulating in the economy, however, quantitative easing instead boosted excess bank reserves, which represent potential money growth and inflation in the years ahead.

The Fed has decided that it can pay banks to hold those reserves, and not push them into the economy. Four rate hikes in 2018 mean the Fed will be paying banks 2.5% per year to hold reserves. Never in history has the Fed tried this. The jury is out. The Fed thinks it will work, we're not so sure. The odds of rising inflation in the next few years, because of those excess reserves, are greater than the chance of a number 16 seed beating a number one seed. Granted, that's not high odds, but we suggest investors, especially in longer-dated fixed income securities, should be worried. Stay tuned.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-21 / 9:00 am	Existing Home Sales – Feb	5.400 Mil	**5.430 Mil**		5.380 Mil
3-22 / 7:30 am	Initial Claims Mar 17	225K	**225K**		226K
3-23 / 7:30 am	Durable Goods – Feb	+1.7%	**+2.5%**		-3.6%
7:30 am	Durable Goods (Ex-Trans) – Feb	+0.5%	**+1.0%**		-0.3%
9:00 am	New Home Sales – Feb	0.624 Mil	**0.626 Mil**		0.593 Mil