First Trust
Monday Morning OUTLOOK
August 27, 2012
630-517-7756 • www.ftportfolios.com

# Still No QE3

**Brian S. Wesbury** – *Chief Economist*
**Robert Stein, CFA** – *Senior Economist*
**Strider Elass** – *Economic Analyst*

The Federal Reserve is clearly ready to do something. In recently released minutes from the 7/31-8/1 meeting *and* a letter from Chairman Bernanke to Congressman Darrell Issa (R-CA), the Fed argued that its actions had helped the economy already and that the Fed was ready to do more.

While we wish the Fed would stop trying to boost economic growth, our wishes are unlikely to be fulfilled. At its next meeting on September 13th, we expect the Fed to change the language of its policy statement and extend the time period it has committed to hold down short-term rates.

At present, the Fed is committed to ultra-low rates until late-2014. But this guidance dates back to January 2012, when the Fed thought the unemployment rate would be about 7.1 – 7.2% in late 2014. Now the Fed's forecast suggests we won't get the jobless rate that low until mid-2015. So, using their own framework, it makes sense for the Fed to commit to an additional six months of near zero interest rates.

Some think the Fed should reduce the interest rate it pays to banks on excess reserves – deposits at the Fed in excess of what the banks are legally required to hold. But the minutes suggest any change here is unlikely, with only a "couple' of members favoring it, while "several" raised concerns. The concerns outweigh the support.

Partly this is because banks would withdraw some deposits from the Fed if they earned less and, in turn, the Fed would have fewer reserves with which to purchase bonds. So banks would buy Treasury bonds from the Fed. This would shrink the Fed's balance sheet, which is the last thing the Fed wants.

In order to expand its balance sheet even more, the Fed must embark on a new round of large-scale asset purchases – or in market short-hand QE3. The minutes show that "many" at the Fed think it would help the economy and only "some…expressed concern" while "several worried." In Fed-speak, "many" trumps "some," but "several" should not be disregarded. The bottom line on QE3 is that it is unlikely right now. The Fed has already extended Operation Twist (buying more long-term Treasury bonds) through the end of 2012 and there still seems to be pushback against more asset purchases.

Nonetheless, "many" members of the Fed thought more accommodation would be needed unless new data showed a "substantial and sustainable strengthening" in economic growth. And even though data after the meeting show a rebound in July (payrolls up 163K, retail sales up 0.8%, and industrial production up 0.5%) none of these data *guarantee* continued acceleration. The Fed set the bar so high for *not* acting, that we expect some kind of announcement.

The best news is that what the Fed will likely do – extend its commitment to low rates – is reversible at any time. It may hold the entire yield curve artificially low, but this will end when the economy begins to accelerate and the market realizes that interest rates must, and will, go higher.

All of this is highly disappointing. The Federal Reserve has never, in all its history, actively interfered with the economic process as much as it has in recent years. Yet, the economy is still growing at an anemic, plow-horse-like 2% real growth rate, with 8.3% unemployment.

We believe that Fed interference can actually hurt growth, but it is fiscal policy mistakes, specifically too much spending and regulatory uncertainty, that are holding the economy back. No one can seriously suggest that there is too little money in the US economy.

But the Fed somehow puts itself in the center of every economic scenario. For slow growth, the Fed automatically assumes that more money is needed. This is a mistake.

The US economy already has enough money to grow. What it really needs is more freedom.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|---|---|---|---|---|---|
| 8-28 / 9:00 am | Consumer Confidence - Aug | 66.0 | **65.0** | | 65.9 |
| 8-29 / 7:30 am | Q2 GDP Second Report | 1.7% | **1.9%** | | 1.5 |
| 7:30 am | Q2 GDP Chain Price Index | 1.6% | **1.6%** | | 1.6 |
| 8-30 / 7:30 am | Initial Claims – Aug 25 | 370K | **369K** | | 372K |
| 7:30 am | Personal Income – Jul | +0.3% | **+0.3%** | | +0.5% |
| 7:30 am | Personal Spending – Jul | +0.4% | **+0.5%** | | +0.0% |
| 8-31 / 8:45 am | Chicago PMI – Aug | 53.5 | **52.0** | | 53.7 |
| 8:55 am | U. Mich Consumer Sentiment | 73.8 | **73.8** | | 73.6 |
| 9:00 am | Factory Orders - Jul | +2.0% | **+2.6%** | | -0.5% |