First Trust
ECONOMIC RESEARCH REPORT
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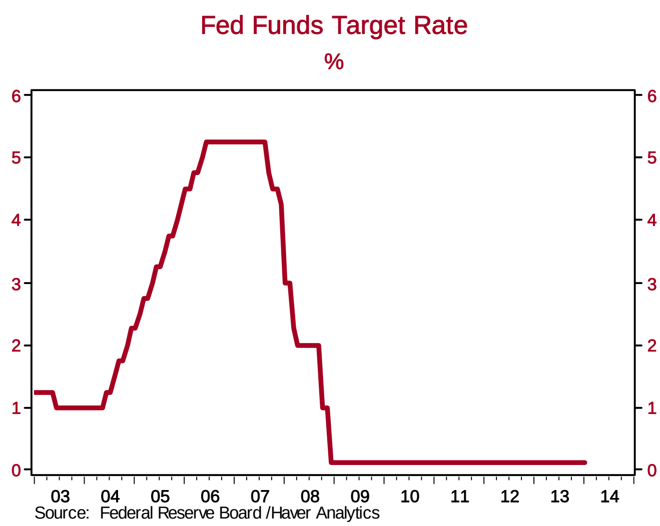
Another Meeting, Another Taper

The Federal Reserve did as expected today, continuing to gradually "taper" quantitative easing. At Chairman Bernanke's final meeting, the Fed announced it would reduce its monthly purchases of Treasury securities and mortgage-backed securities by another $5 billion each ($10 billion total) to $65 billion starting in February. This follows a tapering of $10 billion announced at the last meeting in December. As a result, the size of the Fed's balance sheet will continue to rise, but slightly more slowly than before.

The Fed made other changes to the language of the statement that, on net, signal a slightly more bullish outlook for the economy.

First, the Fed said recent data show "growth in economic activity picked up" rather than "economic activity is expanding at a moderate pace." Although subtle, the new reference to improvement in growth recognizes acceleration. If you're driving 45 mph, you're headed to your destination at a moderate pace; if you get to 50 you're getting there faster.



Second, the Fed said household spending and business investment advanced "more quickly" of late. Third, the Fed said fiscal policy "is" less of a drag on growth, rather than "may be" less of a drag on growth.

The one more bearish comment in the statement was describing labor market indicators as "mixed," which just acknowledges the weaker than expected employment report released a few weeks ago.

The Fed repeated that if the economy continues to behave as it expects, with an improving labor market and inflation moving toward 2%, we should expect further tapering in QE in "measured steps at future meetings." In theory, with seven more meetings in 2014 and QE soon to be $65 billion per month, the process of eliminating QE could take until the end of the year. However, given the First Trust economic forecast – real GDP growth of about 3% with inflation of about 2% – we anticipate the Fed will eventually hasten the pace of tapering and end QE in the third quarter of the year. In turn, we anticipate short-term interest rate hikes to start next year once the unemployment rate dips into the 5.5% to 6% range.

The one change from last year is the absence of any dissents, from either the more hawkish or dovish wings at the Fed (represented by Kansas City Fed Bank President Eshter George and Philadelphia Fed President Eric Rosengren, respectively). This doesn't mean the Fed is now moving in lock-step or that those views disappeared. It's just that the dissenters were automatically rotated off of voting membership this year, and happened to be replaced by bank presidents who are less prone to dissent.

As we have written before, QE, by itself, has not boosted economic growth or equity prices and its withdrawal should not hurt either. Instead, QE has simply added to enormous excess reserves in the banking system. The Fed has used QE as way to signal keeping short-term interest rates low. Now the Fed has evidence it can generate this signal without QE. The recent sell-off in equities is not the start of a bear market. Tapering will continue in 2014 and equities will eventually reverse and move substantially higher.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in December indicates that growth in economic activity picked up in recent quarters. Labor market indicators were mixed but on balance showed further improvement. The unemployment rate declined but remains elevated. Household spending and business fixed investment advanced more quickly in recent months, while the recovery in the housing sector slowed somewhat. Fiscal policy is restraining economic growth, although the *extent of restraint is diminishing. Inflation has been running below the Committee's longer-run objective, but longer-term inflation expectations have remained stable.*

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with appropriate policy accommodation, economic activity will expand at a moderate pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for the economy and the labor market as having become more nearly balanced. The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, and it is monitoring inflation developments carefully for evidence that inflation will move back toward its objective over the medium term.

Taking into account the extent of federal fiscal retrenchment since the inception of its current asset purchase program, the Committee continues to see the improvement in economic activity and labor market conditions over that period as consistent with growing underlying strength in the broader economy. In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions, the Committee decided to make a further measured reduction in the pace of its asset purchases. Beginning in February, the Committee will add to its holdings of agency mortgage-backed securities at a pace of $30 billion per month rather than $35 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $35 billion per month rather than $40 billion per month. The Committee is maintaining its existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative, which in turn should promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate.

The Committee will closely monitor incoming information on economic and financial developments in coming months and will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability. If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings. However, asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's outlook for the labor market and inflation as well as its assessment of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. The Committee also reaffirmed its expectation that the current exceptionally low target range for the federal funds rate of 0 to 1/4 percent will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Richard W. Fisher; Narayana Kocherlakota; Sandra Pianalto; Charles I. Plosser; Jerome H. Powell; Jeremy C. Stein; Daniel K. Tarullo; and Janet L. Yellen.