First Trust
ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Economist*
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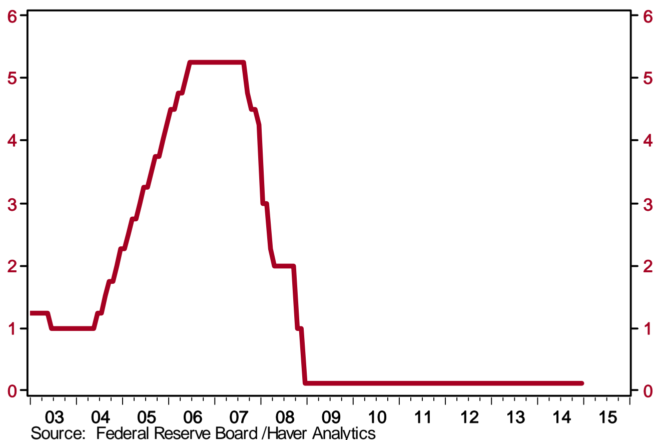
Rate Hikes To Start in 2015

Unlike most meetings, today's actions by the Federal Reserve were chock full of implications for the future course of monetary policy. At long last, the Fed finally removed the language in its statement that short-term interest rates will remain at essentially zero for a "considerable time" and replaced it with language that the Fed will be "patient" before starting to increase rates.

Several months ago, Fed Chair Janet Yellen let it slip that she thinks a "considerable time" means about six months. As a result, we are increasingly confident in our forecast that the first rate hike will come by June 2015, six months from now.



What's striking about the rest of the Fed's policy statement is how focused it is on the labor market, altering the wording of its statement as well as its economic projections slightly here and there to signal its own increased confidence in job creation and declining unemployment.

The obsession with the labor market helps explain why the Fed was willing to look past the recent oil-induced drop in overall inflation. Remember, the Fed doesn't care as much about where inflation is today as where its own models are projecting inflation to go over the next few years. And while it expects inflation to remain low for the time being, it sees this as temporary and that one of the reasons inflation will rebound is improvement in the labor market. The Fed may be the most ardent advocate of the Keynesian Phillips Curve in the world.

When the Fed starts raising rates it is unlikely to raise rates at every meeting, as was done in the past two prolonged rate hike cycles under Alan Greenspan in the late 1990s and Ben Bernanke in the middle of the prior decade. Yellen cautioned against this view at the press conference following the meeting. In addition, the "dot matrix" showing where policymakers think interest rates will go over the next few years suggests the Fed will, for the first year of rate hikes, alternate between raising short-term rates at one meeting and then pausing at the next, making for one rate hike of 25 basis points per quarter through mid-2016.

The "median" dot may suggest a slightly faster pace of rate hikes, but we're guessing that, as the leader of the Fed, Yellen will ultimately get her way and she is probably on the dovish side of the dot matrix. With the highest dot being the most hawkish, Yellen is probably around dot number 12, give or take, and that dot shows three rate hikes in 2015 and six in 2016.

Another issue is when the Fed's balance sheet will go back to normal. We're still forecasting that the Fed will keep reinvesting principal payments from its asset holdings to maintain the balance sheet at roughly $4.4 trillion through at least late 2015.

Notably, this last meeting for 2014 must have been a contentious one. Three members dissented. Once again, Minneapolis Fed president Narayana Kocherlakota disagreed from the dovish side, saying inflation was too low. The two other dissents were from hawks. Dallas President Richard Fisher thought rate hikes should come earlier and Philadelphia President Charles Plosser thought the statement was too focused on the timing of rate hikes rather than the economic conditions that would generate rate hikes. In addition, Plosser thought the statement was not optimistic enough.

The bottom line is that while the Fed is still behind the curve, it's at least finally pointed in the right direction, and, barring some major shift in its outlook for the economy, the clock is ticking on rate hikes. Nominal GDP – real GDP growth plus inflation – is up 4.0% in the past year and up at a 3.9% annual rate in the past two years. A federal funds target rate of nearly zero is too low given this growth. It's also too low given well-tailored policy tools like the Taylor Rule.

In the meantime, hyperinflation is not in the cards; the Fed will keep paying banks enough to keep the money multiplier depressed. But, given loose policy, we expect gradually faster growth in nominal GDP for the next couple of years. In turn, the bull market in equities will continue and the bond market is due for a fall.

Brian S. Wesbury, ***Chief Economist***
Robert Stein, ***Dep. Chief Economist***

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in October suggests that economic activity is expanding at a moderate pace. Labor market conditions improved further, with solid job gains and a lower unemployment rate. On balance, a range of labor market indicators suggests that underutilization of labor resources continues to diminish. Household spending is rising moderately and business fixed investment is advancing, while the recovery in the housing sector remains slow. Inflation has continued to run below the Committee's longer-run objective, partly reflecting declines in energy prices. Market-based measures of inflation compensation have declined somewhat further; survey-based measures of 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, with labor market indicators moving toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for economic activity and the labor market as nearly balanced. The Committee expects inflation to rise gradually toward 2 percent as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate. The Committee continues to monitor inflation developments closely.

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that the current 0 to 1/4 percent target range for the federal funds rate remains appropriate. In determining how long to maintain this target range, the Committee will assess progress--both realized and expected--toward 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 developments. Based on its current assessment, the Committee judges that it can be patient in beginning to normalize the stance of monetary policy. The Committee sees this guidance as consistent with its previous statement that it likely will be appropriate to maintain the 0 to 1/4 percent target range for the federal funds rate for a considerable time following the end of its asset purchase program in October, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored. However, if incoming information indicates faster progress toward the Committee's employment and inflation objectives than the Committee now expects, then increases in the target range for the federal funds rate are likely to occur sooner than currently anticipated. Conversely, if progress proves slower than expected, then increases in the target range are likely to occur later than currently anticipated.

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. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

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. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Stanley Fischer; Loretta J. Mester; Jerome H. Powell; and Daniel K. Tarullo.

Voting against the action were Richard W. Fisher, who believed that, while the Committee should be patient in beginning to normalize monetary policy, improvement in the U.S. economic performance since October has moved forward, further than the majority of the Committee envisions, the date when it will likely be appropriate to increase the federal funds rate; Narayana Kocherlakota, who believed that the Committee's decision, in the context of ongoing low inflation and falling market-based measures of longer-term inflation expectations, created undue downside risk to the credibility of the 2 percent inflation target; and Charles I. Plosser, who believed that the statement should not stress the importance of the passage of time as a key element of its forward guidance and, given the improvement in economic conditions, should not emphasize the consistency of the current forward guidance with previous statements.

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