First Trust
Monday Morning OUTLOOK

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Fed Preview

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No one expects the Federal Reserve to raise rates at the meeting this week. A rate change of any kind, either up or down, would be a complete stunner. Instead, the big news on monetary policy this week is very likely to be the Federal Reserve announcing it will begin gradually trimming its balance sheet at the start of October.

The process of unwinding Quantitative Easing (QE) is going to take time, too much time in our opinion. The Fed has said that whenever it starts, it's going to trim the balance sheet by $10 billion a month for the first three months, $20 billion per month for the next three, and on and on until it hits a pace of $50 billion per month. So, if it starts cutting in October it would take until about 2021 for the balance sheet to reach what we believe is a normalized level.

We think the Fed could get away with being much more aggressive about reducing the balance sheet. We don't think QE helped the economy in the first place; all it did was stuff the banking system full of excess reserves that the banks didn't lend.

However, the Fed is cautious by nature; it hates getting blamed when anything goes wrong. Think about it from their perspective: Let's say they were more aggressive about trimming the balance sheet and suddenly the stock market had one of its inevitable corrections. No matter the actual connection to the Fed's actions, many would blame the Fed.

Meanwhile, the Fed will also drop some hints about a potential rate hike at the end of the year. Those hints could come from both the official statement following the meeting as well as Fed Chief Yellen's press conference afterward, but will certainly come from the "dot plot."

Four times a year, every member of the Fed's Open Market Committee submits a forecast of where interest rates will be at the end of each of the next few years. The Fed then publishes a chart showing these forecasts as anonymous "dots." This dot plot is used by the market to assess the likelihood of interest rate changes.

Back in June, twelve of the sixteen dots showed at least one more rate hike by the end of 2017. Now that a September rate hike isn't going to happen, and given the Fed's reluctance to move at meetings without a scheduled press conference (like on November 1), the number of Fed policymakers projecting at least one rate hike is very likely fewer than twelve. But how many fewer? We're guessing it'll show something like nine or ten (still a majority!) projecting a December rate hike.

If so, that would be a relatively hawkish sign considering the investor consensus embedded in the federal funds futures market at Friday's close showed a slightly less than 50% chance of another rate hike this year. That's up from about a 20% chance a week and a half ago, but still below our view that a December rate hike has about 65% odds.

The Fed isn't the only central bank tilting toward a less loose monetary policy. The Bank of England (BoE) and European Central Bank (ECB) also seem determined to start trimming back on some of the aggressive measures of the past decade. The BoE looks like it will soon move rates up after having cut them to 0.25% in the aftermath of the Brexit vote last year. Meanwhile, the ECB will start tapering its asset purchases. We wish the ECB would also end its experiment with negative short-term rates, but that will likely take more time.

Regardless of what happens in the near future, central banks around the world remain extremely accommodative. None of them are remotely close to running a "tight" monetary policy. Yes, we've discussed the Fed here, but for investors, at this point it's best to ignore the noise. Stocks are still cheap, the Fed is still loose, and the economy is still growing. As long as there are "excess reserves" in the system, monetary policy will not threaten the recovery. If it takes the Fed as long as we think to fully tighten, this recovery will end up being the longest ever.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-19 / 7:30 am	Housing Starts – Aug	1.174 Mil	**1.180 Mil**		1.155 Mil
7:30 am	Export Prices – Aug	+0.2%	**+0.5%**		+0.4%
7:30 am	Import Prices – Aug	+0.2%	**+1.0%**		+0.0%
9-20 / 9:00 am	Existing Home Sales – Aug	5.460 Mil	**5.480 Mil**		5.440 Mil
9-21 / 7:30 am	Philly Fed Index – Sep	17.0	**19.0**		18.9
7:30 am	Initial Claims – Sep 16	300K	**303K**		284K