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FIRST Trust ADVISORS L.P.

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Economic Commentary

Two and Done

Today the Federal Reserve cut both the federal funds rate and discount rate by 25 basis points. The federal funds rate is now 4.5%; the discount rate is now 5%.

Aside from the rate cut, the text of the statement was noticeably less dovish (or more hawkish) than the statement that followed the previous rate cut on September 18. The paragraph on economic growth was more bullish, acknowledging solid economic growth in the third quarter and noting that "strains in financial markets have eased." In addition, the paragraph on inflation was more hawkish, focusing on the potential of energy and commodity price increases to put upward pressure on inflation.

Perhaps the key word in the entire statement was "this," as in "after THIS action, the upside risks to inflation roughly balance the downside risks to growth." In other words, the Fed views today's rate cut differently from the 50 basis point cut in September. The Fed did not see the rate cut in September, by itself, as enough to balance the risks of inflation and slow growth, or at least enough to give them the confidence to opine in public that the risks were balanced.

Now, after today's rate cut, they have that confidence, suggesting today's rate cut is very likely the last, barring substantial new evidence of an economic slowdown or another significant hit to the financial markets. Note that the Fed cut the federal funds rate by a total of 81 basis points after the stock market debacle in 1987 and 75 basis points after the financial market crisis in 1998. Today's action, along with September's brings this cycle's total rate cut to 75 basis points.

Our view is that today's rate cut was unnecessary. The economy grew at nearly a 4% annual rate in Q2 and Q3, will grow at about a 3% rate in Q4, and 3.5% in 2008. Given our bullish view on the economy, we were heartened to see a dissent in favor of no cut in the federal funds rate, by Kansas City Federal Reserve Bank President Thomas Hoenig.

Full text of the Federal Reserve's statement:

The Federal Open Market Committee decided today to lower its target for the federal funds rate 25 basis points to 4-1/2 percent.

Economic growth was solid in the third quarter, and strains in financial markets have eased somewhat on balance. However, the pace of economic expansion will likely slow in the near term, partly reflecting the intensification of the housing correction. Today's action, combined with the policy action taken in September, should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time.

Readings on core inflation have improved modestly this year, but recent increases in energy and commodity prices, among other factors, may put renewed upward pressure on inflation. In this context, the Committee judges that some inflation risks remain, and it will continue to monitor inflation developments carefully.

The Committee judges that, after this action, the upside risks to inflation roughly balance the downside risks to growth. The Committee will continue to assess the effects of financial and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; Timothy F. Geithner, Vice Chairman; Charles L. Evans; Donald L. Kohn; Randall S. Kroszner; Frederic S. Mishkin; William Poole; Eric S. Rosengren; and Kevin M. Warsh. Voting against was Thomas M. Hoenig, who preferred no change in the federal funds rate at this meeting.

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In a related action, the Board of Governors unanimously approved a 25-basis-point decrease in the discount rate to 5 percent. In taking this action, the Board approved the requests submitted by the Boards of Directors of the Federal Reserve Banks of New York, Richmond, Atlanta, Chicago, St. Louis, and San Francisco.

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Robert Stein, ***Senior Economist***
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