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First Trust

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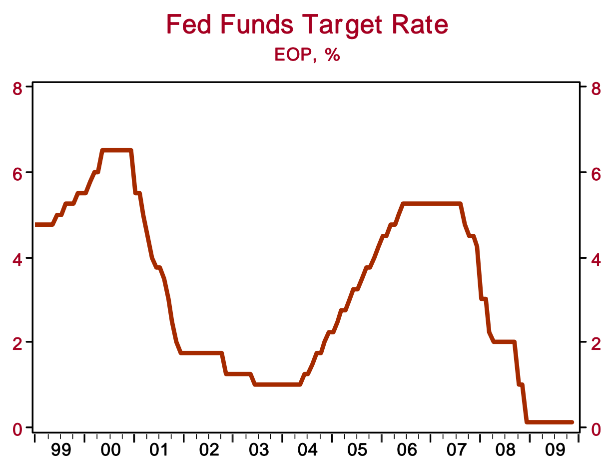
Economic Commentary

Fed Tells Us What Will Lead to Rate Hikes

The Federal Reserve made no direct changes to the stance of monetary policy today, leaving the target range for the federal funds rate at 0% to 0.25%. The language of the statement included three changes, only one of which we think is significant.

The first change was that the Fed acknowledged household spending is now "expanding" rather than "stabilizing." Considering the positive news on auto sales in October, where purchases are now the highest so far this year (excluding the "clunker months" of July and August), it would have been news if the Fed did not recognize the improvement.

The second minor change was to reduce the amount of agency debt the Fed would purchase to $175 billion from $200 billion. The Fed says this shift was due to the supply of agency debt available for sale.



The third change, and the most significant one, was that the Fed provided reasons for keeping the federal funds rate in a range of 0% to 0.25% for an "extended period." The justifications for low interest rates include "low rates of resource utilization, subdued inflation trends, and stable inflation expectations." In other words, the Fed is not going to raise rates until it sees some combination of declining unemployment, higher inflation trends – such as higher "core" inflation, which excludes food and energy prices – or higher inflation expectations.

Given our forecast that the unemployment rate will very soon reach a peak and inflation will be moving upward in 2010, the Fed statement is consistent with our view that the Fed will begin to lift the federal funds rate sometime in the Spring or early Summer.

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Robert Stein, *Senior Economist*

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in September suggests that economic activity has continued to pick up. Conditions in financial markets were roughly unchanged, on balance, over the intermeeting period. Activity in the housing sector has increased over recent months. Household spending appears to be expanding but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment and staffing, though at a slower pace; they continue to make progress in bringing inventory stocks into better alignment with sales. Although economic activity is likely to remain weak for a time, the Committee anticipates that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will support a strengthening of economic growth and a gradual return to higher levels of resource utilization in a context of price stability.

With substantial resource slack likely to continue to dampen cost pressures and with longer-term inflation expectations stable, the Committee expects that inflation will remain subdued for some time.

In these circumstances, the Federal Reserve will continue to employ a wide range of tools to promote economic recovery and to preserve price stability. The

Committee will maintain the target range for the federal funds rate at 0 to 1/4 percent and continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of $1.25 trillion of agency mortgage-backed securities and about $175 billion of agency debt. The amount of agency debt purchases, while somewhat less than the previously announced maximum of $200 billion, is consistent with the recent path of purchases and reflects the limited availability of agency debt. In order to promote a smooth transition in markets, the Committee will gradually slow the pace of its purchases of both agency debt and agency mortgage-backed securities and anticipates that these transactions will be executed by the end of the first quarter of 2010. The Committee will continue to evaluate the timing and overall amounts of its purchases of securities in light of the evolving economic outlook and conditions in financial markets. The Federal Reserve is monitoring the size and composition of its balance sheet and will make adjustments to its credit and liquidity programs as warranted.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Charles L. Evans; Donald L. Kohn; Jeffrey M. Lacker; Dennis P. Lockhart; Daniel K. Tarullo; Kevin M. Warsh; and Janet L. Yellen.

This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.