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First Trust

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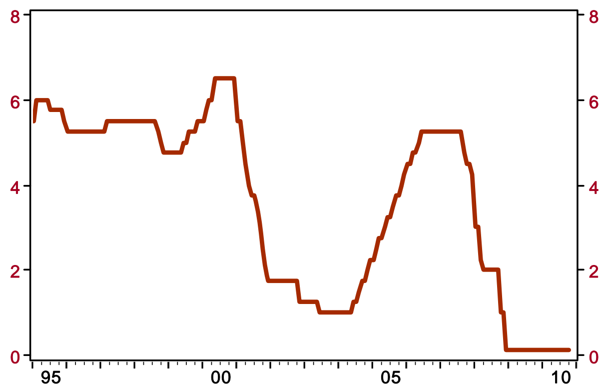
Economic Commentary

Fed Embarks on QEII

The Federal Reserve made it official: it is embarking on another round of quantitative easing. To be specific, it will buy an additional $600 billion in long-term Treasury securities from now through the middle of 2011 ($75 billion per month).

This is on top of its commitment to reinvest (into long-term Treasury securities) principal payments on its pre-existing portfolio of mortgage securities. In addition, the Fed made it clear that although the program of purchasing more securities will start with an end date in mind (mid-2011), the Fed will regularly assess whether to lengthen and/or expand the program based on the nature of incoming economic and financial data.



As everyone expected, 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 Fed also made no changes to its commitment to keep the funds rate at this level for an "extended period." Some analysts had suggested, given the mid-year deceleration of economic growth, that the Fed would somehow make this commitment even more iron-clad.

However, in addition to another round of quantitative easing, the Fed did make some notable changes to its statement, generally signaling more concern about the economic recovery. First, the Fed now says that information "confirms," rather than "indicates," economic weakness. Second, the Fed says economic progress has been "disappointingly slow" rather than suggesting progress will be "modest in the near term." On the brighter side, the Fed omitted a prior reference to a contraction in bank lending.

Once again, Kansas City Fed President Thomas Hoenig was the only dissent to the Fed's policy changes.

We believe the Fed's new round of quantitative easing will have little to no impact on the larger economy. Banks already hold roughly $1 trillion in excess reserves. Adding to this pile of reserves will not influence the desire of financial institutions to lend, nor will it lead to any near-term increase in the supply of currency in circulation. All it will do is sit idle on the liability side of the Fed's balance sheet and on the asset side for the banks.

More importantly, the economy is already accelerating. The four-week moving average of new claims for unemployment insurance is declining again. Wages and total hours worked are rising in the private sector. Auto sales are the highest in more than two years (except for cash-for-clunkers). Businesses are consistently increasing investment in equipment. Given these trends and what we think will be an offset to anomalies in trade data the past two quarters, we believe real GDP growth will come in at close to a 5% annual rate in the current quarter.

In other words, Hoening is right and the Fed will eventually come to regret its latest decision.

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

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in September confirms that the pace of recovery in output and employment continues to be slow. Household spending is increasing gradually, but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit. Business spending on equipment and software is rising, though less rapidly than earlier in the year, while investment in nonresidential structures continues to be weak. Employers remain reluctant to add to payrolls. Housing starts continue to be depressed. Longer-term inflation expectations have remained stable, but

measures of underlying inflation have trended lower in recent quarters.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. Currently, the unemployment rate is elevated, and measures of underlying inflation are somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate. Although the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, progress toward its objectives has been disappointingly slow.

To promote a stronger pace of economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate, the Committee decided today to expand its holdings of securities. The Committee will maintain its existing policy of reinvesting principal payments from its securities holdings. In addition, the Committee intends to purchase a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about $75 billion per month. The Committee will regularly review the pace of its securities purchases and the overall size of the asset-purchase program in light of incoming information and will adjust the program as needed to best foster maximum employment and 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 for the federal funds rate for an extended period.

The Committee will continue to monitor the economic outlook and financial developments and will employ its policy tools as necessary to support the economic recovery and to help ensure that inflation, over time, is at levels consistent with its mandate.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Sandra Pianalto; Sarah Bloom Raskin; Eric S. Rosengren; Daniel K. Tarullo; Kevin M. Warsh; and Janet L. Yellen.

Voting against the policy was Thomas M. Hoenig. Mr. Hoenig believed the risks of additional securities purchases outweighed the benefits. Mr. Hoenig also was concerned that this continued high level of monetary accommodation increased the risks of future financial imbalances and, over time, would cause an increase in long-term inflation expectations that could destabilize the economy.

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.