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First Trust

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Monday Morning Outlook

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The Danger of Zero Percent Interest Rates

The Federal Open Market Committee (FOMC) – the arm of the Federal Reserve that makes monetary policy – will meet on Tuesday and Wednesday to discuss its target for short-term interest rates. It will also discuss other issues, such as what to do with its huge balance sheet of mortgage assets that ran up during the height of the financial panic.

The economy is outperforming the Fed's forecast, creating a dilemma. Before massive snowstorms, the Fed projected that real GDP would grow 3.1% in 2010. Our forecast for Q1 real GDP is 3.4% despite record-breaking storms. And we expect Q2 real GDP growth to approach 6%.

In the past six months, retail sales are up at an 11.7% annual rate, new orders for "core" capital goods (excluding aircraft and defense) are up at a 12.4% rate, and housing starts are up at a 14.1% rate. And with this kind of growth, the labor market has turned the corner. In the past three months, private sector payrolls are up 49,000 per month. In the same three months, civilian employment – an alternative measure of jobs that includes small business start-ups and the self-employed – is up 1.356 million (the most for any three-month period since 1994). And, corporations are blowing away earnings estimates.

With each passing day, data like these make the Fed's zero percent interest rates less and less appropriate. So much so that we believe it is past time to start raising them. Of course, doing so at this week's meeting would have required laying the right foundation, which means using speeches and testimony to signal the Fed's confidence that the economy is able to handle higher interest rates. But this has not happened. As a result, we would be almost as shocked as everyone else if the Fed actually pulls the trigger and lifts rates this week.

Instead, we expect that the Fed will move away from its commitment to keep interest rates near zero percent for an "extended period." The Fed is likely to replace this language with some kind of weaker commitment – a signal that rates will be headed up no later than the September meeting.

The Fed is also going to have a debate about selling its unprecedented portfolio of more than $1 trillion in mortgage-backed securities (MBS). It has been reported that some of the Fed's regional bank presidents support this action. Minneapolis Fed Bank President Kocherlakota has said the Fed should sell about $20 billion per month for the next five years for the Fed to rid itself of MBS.

We believe this would be a mistake. Not because the market could not absorb these securities, but because their sale would not represent tighter monetary policy. In order to tighten policy, and avoid even higher inflation in the future, the Fed must push the federal funds rate back toward a neutral level. With real GDP running at a 4%+ annual rate, there is no way to justify zero percent interest rates.

The Fed should just allow the bulk of its mortgage holdings to run-off through principal repayments and mortgage re-financings. As it does so, it can repay Treasury borrowings and allow banks to convert excess reserves to other kinds of assets. (Of course, if banks start to lend out excess reserves, those they currently hold with the Fed, asset sales might be forced.) What we think the Fed should avoid is becoming too disruptive in the financial system. Running up their balance sheet and then running it down is not an efficient or productive way of managing monetary policy.

The debate over sales of MBS is an unnecessary diversion from the Fed's primary mission of keeping the value of the dollar stable. The Fed's MBS portfolio is not "crowding out" its ability to hold Treasury securities. The Fed owns $777 billion in Treasuries, almost exactly what it owned in 2006, before the financial panic started.

And even when short-term rates start to rise, the stance of policy will remain loose, meaning there will still be some upward pressure on the balance sheet of the Fed, which it can satisfy by buying more Treasuries. In other words, continuing to hold MBS is not going to force the Fed to liquidate its traditional Treasury portfolio anytime soon, nor will it interfere with traditional management of monetary policy.

The Fed has become overly involved in financial markets and it is losing sight of its number one job – maintaining price stability. In this vein, zero percent interest rates are becoming more dangerous every day.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-27 / 9:00 am	Consumer Confidence - Apr	53.5	**51.4**		52.5
4-29 / 7:30 am	Initial Claims - Apr 24	445K	**447K**		456K
4-30 / 7:30 am	Q1 GDP Advance	+3.4%	**+3.4%**		+5.6%
7:30 am	Q1 GDP Chain Price Index	+0.9%	**+1.0%**		+0.5%
9:00 am	Chicago PMI - Apr	60.0	**59.1**		58.8
8:45 am	U. Mich. Consumer Sentiment	71.0	**71.0**		69.5