First Trust
ECONOMIC RESEARCH REPORT
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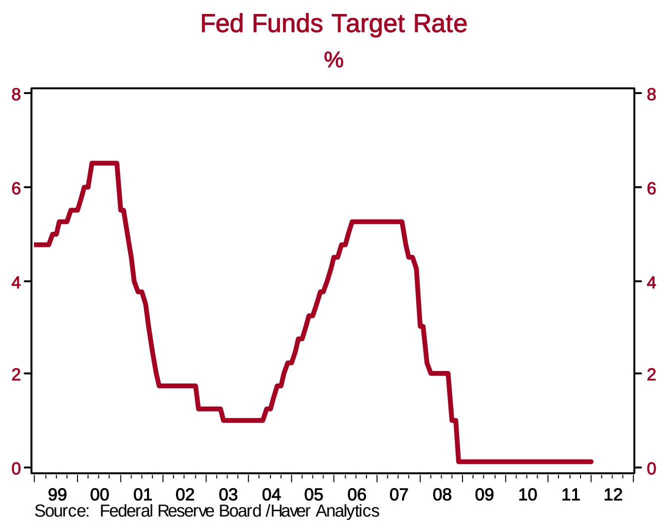
Fed Language Goes Dovish, But Policy Unchanged

The most important thing to remember about today's Federal Reserve meeting is that monetary policy ended the day exactly as it started: no more loose, no less loose, but still too loose.

The big news was that the Fed changed its policy expectation to maintain exceptionally low rates to late 2014 from mid-2013. However, this change has no impact on the *current* stance of monetary policy, which we believe is best measured by the gap between the federal funds rate and the trend growth rate in nominal GDP (real GDP growth plus inflation).



Source: Federal Reserve Board /Haver Analytics

The Fed also made some other edits to the language of the statement. The most important was removing a sentence that the Fed "will continue to pay close attention to the evolution of inflation and inflation expectations." The removal of this language is consistent with the Fed's willingness to prolong the period of essentially zero percent short-term rates, which is destined to generate more inflation down the road.

The Fed also added language saying it "expects to maintain a highly accommodative stance for monetary policy," but, at this point, that's just restating the obvious. Other more minor changes include acknowledging "further" improvement in the labor market and inserting more definite wording on recent slower growth in business investment (which we think is temporary). The last noteworthy change to the language was saying that growth over coming quarters will be "modest," rather than "moderate."

Otherwise, the Fed made no changes to interest rates, the size of its balance sheet, or its policy of paying interest on excess reserves. In other words, no third round of quantitative easing. Given the re-acceleration in the economy we continue to think QE3 is a ship that will never sail.

In terms of its balance sheet, the Fed reiterated what it originally said in September, that it would keep rolling over the principal payments it receives so that the sizes of its Treasury portfolio and mortgage security portfolio would remain unchanged.

Unlike in November when the only dissenter wanted more policy accommodation, the lone dissent this month came from Richmond Bank President Jeffrey Lacker, who would have preferred the Fed not publicly commit to a time period for exceptionally low interest rates.

The big innovation in today's meeting was that the Fed provided not only a new economic forecast but also a record of what Fed officials currently think the target federal funds rate will be at the end of each of the next few years as well as over the long-run target.

The Fed anticipates real GDP growth of 2.4% in 2012 (Q4/Q4), down from a November forecast of 2.7%. For 2013, its real GDP forecast dipped to 3% from 3.2%. Despite lower real GDP projections, its forecast for the unemployment rate in Q4 2012 dropped to 8.35% from 8.6% and for Q4 2013 dropped to 7.75% from 8%. The Fed's forecast of the "long-run" unemployment rate remained at 5.6%. Also of note, the Fed's long-run goal for inflation is now 2% even rather than a range between 1.7% and 2%.

The new information on officials' expectations of the appropriate fed funds target shows a median that would make no change in policy either this year or next year and lift the funds rate to only 0.75% by the end of 2014. Over the long run, the consensus favors a funds rate of about 4.25%.

However, investors should take note that at his press conference today Chairman Bernanke made it clear that if the Fed's economic forecast proves either too optimistic or too pessimistic, that it would change its forecast and alter its policy expectations for the funds rate as well. The importance of this statement cannot be underestimated. We anticipate faster economic growth, lower unemployment, and higher inflation than the Fed projects over the next few years. As result, we believe the Fed will start raising interest rates well before late 2014.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in December suggests that the economy has been expanding moderately, notwithstanding some slowing in global growth. While indicators point to some further improvement in overall labor market conditions, the unemployment rate remains elevated. Household spending has continued to advance, but growth in business fixed investment has slowed, and the housing sector remains depressed. Inflation has been subdued in recent months, and longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects economic growth over coming quarters to be modest and consequently anticipates that the unemployment rate will decline only gradually toward levels that the Committee judges to be consistent with its dual mandate. Strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee also anticipates that over coming quarters, inflation will run at levels at or below those consistent with the Committee's dual mandate.

To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate, the Committee expects to maintain a highly accommodative stance for monetary policy. In particular, the Committee decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014.

The Committee also decided to continue its program to extend the average maturity of its holdings of securities as announced in September. The Committee is maintaining its existing policies of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities and of rolling over maturing Treasury securities at auction. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate to promote a stronger economic recovery in a context of price stability.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Dennis P. Lockhart; Sandra Pianalto; Sarah Bloom Raskin; Daniel K. Tarullo; John C. Williams; and Janet L. Yellen. Voting against the action was Jeffrey M. Lacker, who preferred to omit the description of the time period over which economic conditions are likely to warrant exceptionally low levels of the federal funds rate.