First Trust
ECONOMIC RESEARCH REPORT

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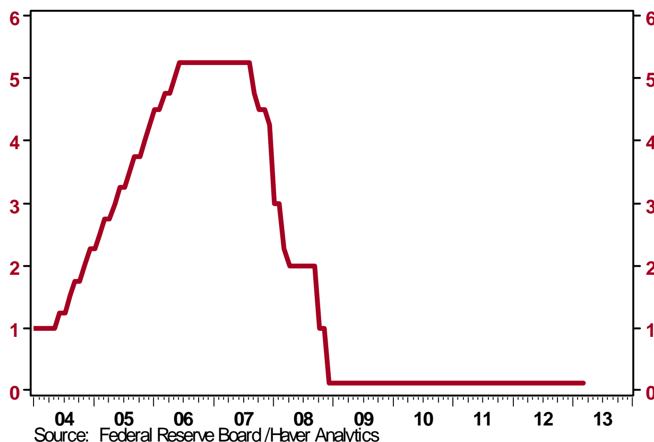
March 20, 2013 • 630.517.7756 • www.ftportfolios.com

Fed Still Inching Toward Optimism

The Federal Reserve made no changes to monetary policy today and only some small changes to the language of its statement. Once again, the Fed's comments were slightly more optimistic about the economy than they were after the prior meeting.

The Fed noted an end to the weather-related pause in growth near the end of 2012 and start of 2013, saying economic growth had returned to a moderate rate. It also recognized recent improvements in the labor market and deleted language that had previously described employment gains as "moderate." The move suggests the Fed thinks recent job gains are better than moderate. The Fed also upgraded its assessment of the housing recovery, saying it has "strengthened further."



Two changes to the statement were slightly more bearish. First, the Fed said fiscal policy had become more restrictive, a reference to the recent federal spending sequester. (Unlike the Fed, we think the sequester boosts business confidence, helping growth. The S&P 500 is up 3% since March 1, when the sequester went into effect.) Second, the Fed removed a reference to an ease in strains in global financial markets. The change was probably a reaction to recent news out of Cyprus.

As everyone expected, the Fed maintained its open-ended commitment to buy additional mortgage-backed securities at a pace of $40 billion per month and more long-term Treasury securities at a pace of $45 billion per month. Once again, Kansas City Fed Bank President Esther George dissented from the Fed's decision, concerned that loose monetary policy could create future economic and financial imbalances as well as higher long-term inflation expectations.

The Fed used the meeting to develop a new set of economic projections. It's forecast for real GDP growth and inflation did not change in any significant way. However, given the importance of the 6.5% unemployment threshold for raising short-term rates any change in that particular projection is important and the Fed's forecast for that indicator did fall slightly for 2013-14.

The Fed now expects the unemployment rate to end 2013 at 7.4% (previously 7.55%) and end 2014 at 6.85% (previously 7.05%). Although the Fed's expectation for the end of 2015 is essentially unchanged, the changes for 2013-14 suggest it thinks we will hit the 6.5% threshold in July or August 2015 rather than September 2015. By contrast, we still think the threshold will be reached around mid-2014.

Despite the change in economic projections, there were no significant changes in the Fed's projections for short-term rates. The last time the Fed released its forecast, in December, two of nineteen members of the FOMC (Federal Open Market Committee) thought rates should go up in 2013; now it's only one. The same number of members – five of nineteen – think rates should rise in 2014. Similarly, there were no changes in the median expected federal funds rate at the end of 2015 (1%) or the median expected long-term average for the federal funds rate (4%).

Notably, at his press conference, Fed Chairman Bernanke made it clear that the 6.5% unemployment rate will not *automatically* trigger higher short term rates and that much time may pass between the Fed ending its purchase of assets and finally raising rates.

This is unfortunate. Like we have said many times before, QE3 will simply add to the already enormous excess reserves in the banking system, not deal with the underlying causes of economic weakness, including the growth in government spending, excessive regulation, and expectations of higher future tax rates. QE3 will not add anything to economic growth and, as long as banks are reluctant to lend aggressively, not cause hyper-inflation either.

Nominal GDP – real GDP plus inflation – is already growing in the 3.5% to 4% range. At that pace, the economy can already sustain a much higher federal funds rate than now prevails. Maintaining rates near zero percent will eventually lead to inflation running consistently above the Fed's 2% target, which means once it starts raising rates the peak will be higher than 4%, perhaps much higher.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in January suggests a return to moderate economic growth following a pause late last year. Labor market conditions have shown signs of improvement in recent months but the unemployment rate remains elevated. Household spending and business fixed investment advanced, and the housing sector has strengthened further, but fiscal policy has become somewhat more restrictive. Inflation has been running somewhat below the Committee's longer-run objective, apart from temporary variations that largely reflect fluctuations in energy prices. 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 that, with appropriate policy accommodation, economic growth will proceed at a moderate pace and the unemployment rate will gradually decline toward levels the Committee judges consistent with its dual mandate. The Committee continues to see downside risks to the economic outlook. The Committee also anticipates that inflation over the medium term likely will run at or below its 2 percent objective.

To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee decided to continue purchasing additional agency mortgage-backed securities at a pace of $40 billion per month and longer-term Treasury securities at a pace of $45 billion per month. The Committee is maintaining its existing policy 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. Taken together, these actions should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

The Committee will closely monitor incoming information on economic and financial developments in coming months. The Committee will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until the outlook for the labor market has improved substantially in a context of price stability. In determining the size, pace, and composition of its asset purchases, the Committee will continue to take appropriate account of the likely efficacy and costs of such purchases as well as the extent of progress toward its economic objectives.

To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; James Bullard; Elizabeth A. Duke; Charles L. Evans; Jerome H. Powell; Sarah Bloom Raskin; Eric S. Rosengren; Jeremy C. Stein; Daniel K. Tarullo; and Janet L. Yellen. Voting against the action was Esther L. George, who was concerned that the continued high level of monetary accommodation increased the risks of future economic and financial imbalances and, over time, could cause an increase in long-term inflation expectations.

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