First Trust
ECONOMIC RESEARCH REPORT
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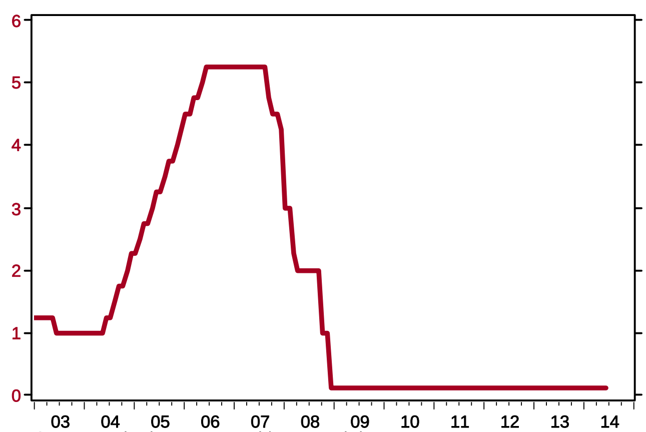
Improving Economy, Weaker Guideposts

Apparently, an improving labor market and higher inflation are not enough to get any signal from the Federal Reserve that short-term interest rates should be higher or QE should end faster than they thought before.

The Fed did what almost everyone expected, leaving short-term rates unchanged and continuing to taper by $10 billion per meeting. As a result, the Fed will buy $25 billion in bonds in August and remains on a path to end quantitative easing at the end of October.

The Fed did make some important changes to the wording of its statement. On the labor market, it removed language saying the jobless rate "remains elevated." It's about time considering how consistently the unemployment rate has been dropping faster than the Fed has anticipated.



Source: Federal Reserve Board /Haver Analytics

But the Fed also added important new language, saying "a range of labor market indicators suggests that there remains significant underutilization of labor resources." So, despite the jobless rate approaching the Fed's long-term objective, the Fed isn't going to provide any firm guideposts on how changes in the labor market are going to influence monetary policy. This is very opaque – the opposite of transparency.

Meanwhile, the Fed acknowledged inflation is approaching its long-term target of 2% and removed language about how inflation running persistently below 2% could hurt the economy. However, it's important to note that what matters most to the Fed isn't actual inflation but its *own* forecast of future inflation. And the Fed has yet to issue a forecast that shows inflation higher than 2%.

Unlike the last meeting in June, there was one dissent from a Hawk. Philadelphia Fed bank President Charles Plosser, who thought the Fed shouldn't pre-commit to leaving rates low for a "considerable period" after QE ends. After his editorial in the Wall Street Journal, we thought Richard Fisher, President of the Dallas Fed would dissent, but surprise, surprise, he voted with the majority. We assume he was mollified by the minor changes in language to the Fed statement.

Overall, today's statement is consistent with our view that the Fed is already behind the curve and will end up accepting higher inflation in the longer-run than its current 2% target. Fed policy is easy, the Fed is making a commitment to keep its balance sheet larger for longer, and it sees no real urgency to raise rates. All of this will create a boost for equity markets and the economy over the next 12-24 months. And we still think the bond market does not appreciate the danger it faces.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in June indicates that growth in economic activity rebounded in the second quarter. Labor market conditions improved, with the unemployment rate declining further. However, a range of labor market indicators suggests that there remains significant underutilization of labor resources. Household spending appears to be rising moderately and business fixed investment is advancing, while the recovery in the housing sector remains slow. Fiscal policy is restraining economic growth, although the extent of restraint is diminishing. Inflation has moved somewhat closer to the Committee's longer-run objective. 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 activity will expand at a moderate pace, with labor market indicators and inflation *moving toward levels the Committee judges consistent with its dual mandate. The Committee sees the risks to the outlook for economic activity and the labor market as nearly balanced and judges that the likelihood of inflation running persistently below 2 percent has diminished somewhat.*

The Committee currently judges that there is sufficient underlying strength in the broader economy to support ongoing improvement in labor market conditions. In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions since the inception of the current asset purchase program, the Committee decided to make a further measured reduction in the pace of its asset purchases. Beginning in August, the Committee will add to its holdings of agency mortgage-backed securities at a pace of $10 billion per month rather than $15 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $15 billion per month rather than $20 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. The Committee's sizable and still-increasing holdings of longer-term securities should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative, which in turn should promote a stronger economic recovery and help to ensure that inflation, over time, is at the rate most consistent with the Committee's dual mandate.

The Committee will closely monitor incoming information on economic and financial developments in coming months and 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. If incoming information broadly supports the Committee's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Committee will likely reduce the pace of asset purchases in further measured steps at future meetings. However, asset purchases are not on a preset course, and the Committee's decisions about their pace will remain contingent on the Committee's outlook for the labor market and inflation as well as its assessment of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy remains appropriate. In determining how long to maintain the current 0 to 1/4 percent target range for the federal funds rate, the Committee will assess progress--both realized and expected--toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored.

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. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; Stanley Fischer; Richard W. Fisher; Narayana Kocherlakota; Loretta J. Mester; Jerome H. Powell; and Daniel K. Tarullo. Voting against was Charles I. Plosser who objected to the guidance indicating that it likely will be appropriate to maintain the current target range for the federal funds rate for "a considerable time after the asset purchase program ends," because such language is time dependent and does not reflect the considerable economic progress that has been made toward the Committee's goals.