First Trust
ECONOMIC RESEARCH REPORT

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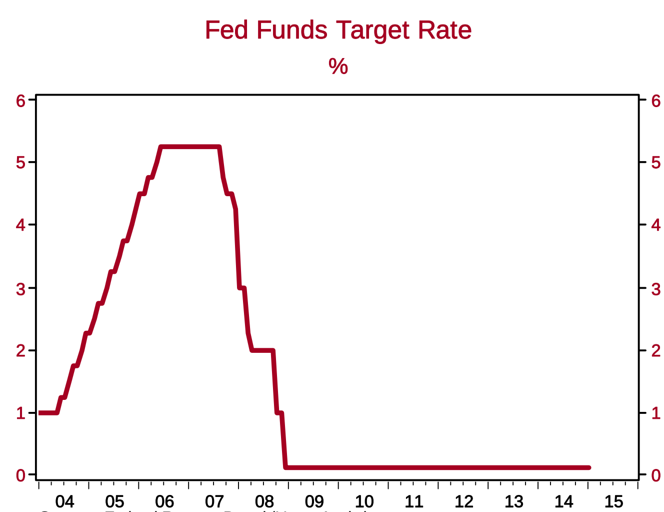
January 28, 2015 • 630.517.7756 • www.ftportfolios.com

Rate Hikes Still A Few Meetings Away

No one expected the Federal Reserve to make any changes to monetary policy at today's meeting and there were no surprises. The Fed continued to say it would be "patient" before raising short-term interest rates, which means the Fed is very unlikely to raise rates through at least April.

However, the Fed did make some noticeable changes to the language in the statement, upgrading its assessment of both economic growth and the labor market, while recognizing both lower inflation (due to falling energy prices) and lower market-based measures of inflation expectations. Ultimately, though, the Fed's forecast is that the eventual end of energy price declines as well as the improving labor market will push inflation back up toward its target of 2%.



Source: Federal Reserve Board /Haver Analytics

Unlike the past several meetings, this one appears to have been much less contentious. Three voting members dissented at the December meeting; this time, no one dissented, the first time that's happened since the meeting in June 2014. Both the hawks and doves who previously dissented are no longer voting members this year.

All of this is consistent with our view that the Fed is still on track to start raising rates in June. It is unlikely to raise rates at every meeting, as was done in the past two prolonged rate hike cycles under Alan Greenspan in the late 1990s and Ben Bernanke in the middle of the prior decade. Instead, the Fed will probably raise rates at every other meeting for the first year, before embarking on a more aggressive path in the second half of 2016 and beyond.

Another issue is when the Fed's balance sheet will go back to normal. We're still forecasting that the Fed will keep reinvesting principal payments from its asset holdings to maintain the balance sheet at roughly $4.4 trillion through at least late 2015.

The bottom line is that while the Fed is still behind the curve, it's at least finally pointed in the right direction, and, barring some major shift in its outlook for the economy, the clock is ticking on rate hikes. Nominal GDP – real GDP growth plus inflation – is up 4.3% in the past year and up at a 4.0% annual rate in the past two years. A federal funds target rate of nearly zero is too low given this growth. It's also too low given well-tailored policy tools like the Taylor Rule.

In the meantime, hyperinflation is not in the cards; the Fed will keep paying banks enough to keep the money multiplier depressed. But, given loose policy, we expect gradually faster growth in nominal GDP for the next couple of years. In turn, the bull market in equities will continue and the bond market is due for a fall.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in December suggests that economic activity has been expanding at a solid pace. Labor market conditions have improved further, with strong job gains and a lower unemployment rate. On balance, a range of labor market indicators suggests that underutilization of labor resources continues to diminish. Household spending is rising moderately; recent declines in energy prices have boosted household purchasing power. Business fixed investment is advancing, while the recovery in the housing sector remains slow. Inflation has declined further below the Committee's longer-run objective, largely reflecting declines in energy prices. Market-based measures of inflation compensation have declined substantially in recent months; survey-based measures of 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 continuing to *move toward levels the Committee judges consistent with its dual mandate. The Committee continues to see the risks to the outlook for economic activity and the labor market as nearly balanced. Inflation is anticipated to decline further in the near term, but the Committee expects inflation to rise gradually toward 2 percent over the medium term as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate. The Committee continues to monitor inflation developments closely.*

To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that the current 0 to 1/4 percent target range for the federal funds rate remains appropriate. In determining how long to maintain this target range, 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 and international developments. Based on its current assessment, the Committee judges that it can be patient in beginning to normalize the stance of monetary policy. However, if incoming information indicates faster progress toward the Committee's employment and inflation objectives than the Committee now expects, then increases in the target range for the federal funds rate are likely to occur sooner than currently anticipated. Conversely, if progress proves slower than expected, then increases in the target range are likely to occur later than currently anticipated.

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. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

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; Charles L. Evans; Stanley Fischer; Jeffrey M. Lacker; Dennis P. Lockhart; Jerome H. Powell; Daniel K. Tarullo; and John C. Williams.