First Trust
ECONOMIC RESEARCH REPORT
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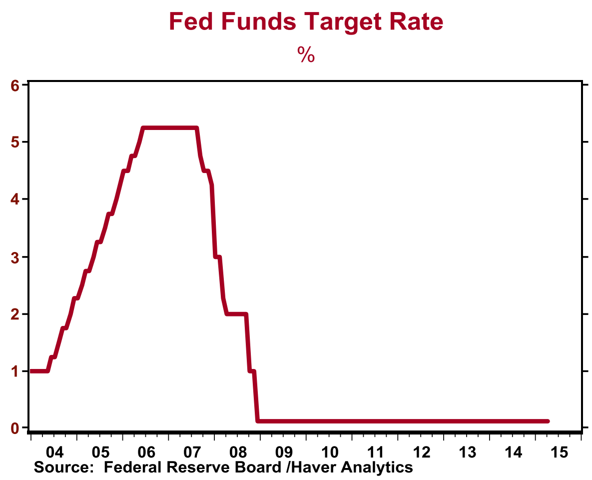
Key Seven Weeks Starts Now

Don't be confused by the Federal Reserve acknowledging the obvious slowdown in economic growth in the first quarter. The door to a June rate hike is still open. Not wide open, but much more open than most analysts and investors think.

The Fed's statement mentioned slower growth in output, consumer spending, business investment, exports, and job creation. But it also hinted at faster growth ahead by mentioning how lower energy prices mean faster gains in "real" (inflation-adjusted) incomes.



Other analysts may point to Fed language that the recent slowdown only "in part" reflects "transitory factors." In turn, they may argue this means the Fed thinks some of the recent slowdown may be longer lasting. But the Fed said almost the same thing last year, stating the slowdown last winter was "in part" due to "adverse weather conditions." That's right before real GDP expanded at a 4.8% annual rate in the middle two quarters of 2014. In other words, we think the Fed is just hedging its bets.

One subtle change in the statement was removing the sentence from the March statement where the Fed said "an increase in the target range for the federal funds rate remains unlikely at the April FOMC meeting." If the Fed was already convinced a June rate hike won't happen, they could have just replaced "April" with "June." But they didn't, which means the Fed is still set to consider a rate hike at the meeting in seven weeks.

Also notice that the Fed thinks that maintaining the large size of its balance sheet is a form of accommodation, which means slightly higher rates is only one way of making the Fed less loose and the other way of making the Fed less loose won't happen for some time after it starts lifting rates.

Between now and the Meeting in June, we will get two more reports on the employment situation, two more reports on retail sales, plus lots of other data. If the economy doesn't rebound then the Fed won't raise rates in June. If the economy does rebound, as we expect, then we still think a June rate hike is more likely than not.

The Yellen Fed is data dependent and its statement makes it clear the Fed is willing to start raising rates when it is "reasonably confident" the labor market and inflation are heading up. Moreover, we believe the data already say the economy can handle higher rates. Nominal GDP is up 3.6% annualized in the past two years, not much below the 4.4% annual pace of the past 20 years, when the federal funds rate has averaged 2.8%. 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.

Keep in mind, though, if the Fed starts raising rates soon, it's 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 both Alan Greenspan 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.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in March suggests that economic growth slowed during the winter months, in part reflecting transitory factors. The pace of job gains moderated, and the unemployment rate remained steady. A range of labor market indicators suggests that underutilization of labor resources was little changed. Growth in household spending declined; households' real incomes rose strongly, partly reflecting earlier declines in energy prices, and consumer sentiment remains high. Business fixed investment softened, the recovery in the housing sector remained slow, and exports declined. Inflation continued to run below the Committee's longer-run objective, partly *reflecting earlier declines in energy prices and decreasing prices of non-energy imports. Market-based measures of inflation compensation remain low; 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. Although growth in output and employment slowed during the first quarter, the Committee continues to expect 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 remain near its recent low level 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 declines in energy and import prices 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. The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term.

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.