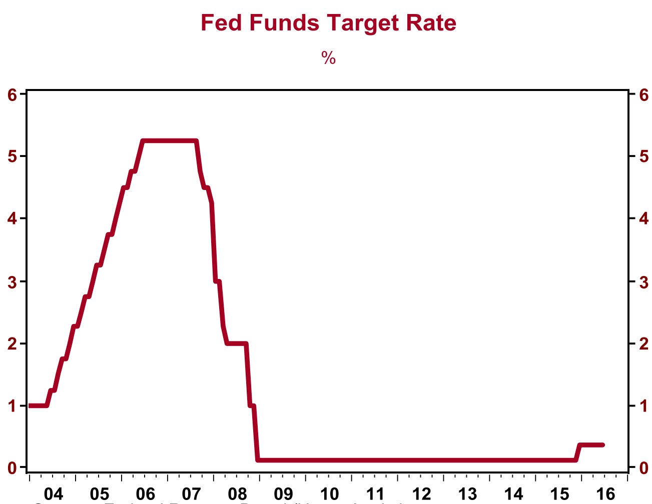
First Trust
ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Economist*
June 15, 2016 • 630.517.7756 • www.ftportfolios.com

Fed Projects Very Slow Path for Rate Hikes

At her post-meeting press conference Fed Chief Janet Yellen emphasized that it's important not to "overreact" to one or two reports on the economy. But that's exactly what the Fed did by refraining from raising rates at today's meeting and notably altering its projections for future rate hikes.

Although the Fed stuck to its projection of two 25 basis point rate hikes in 2016, the projected path for future years came down. Back in March, the median forecast at the Fed suggested at least 2 percentage points (200 basis points) of rate hikes in 2017 and 2018, combined. Now the median forecast is for an increase of 1.5 percentage points (150 basis points) over the same time frame.

In addition, the Fed once again brought down its estimate of the long-term average for the federal funds rate. As recently as December, the Fed pegged the long-term average at 3.5%. That came down to 3.25% in March and is now only 3%.



Source: Federal Reserve Board /Haver Analytics

What's odd about the changes in the expected path for rate hikes is that it was not accompanied by any significant changes in the economic outlook. Real GDP growth was downgraded very slightly for 2016-17, but the inflation forecast was revised up slightly, leaving the pace of nominal GDP growth essentially unchanged.

The Fed made some changes to the language in its official statement, but nothing earthshattering. The Fed acknowledged slower improvement in the labor market but faster growth in the overall economy, exactly the opposite of what it said back in April, consistent with recent economic reports. On the hawkish side, the Fed noted better household spending and less of a drag from exports. However, the Fed pleased the doves by mentioning lower market-based measures of inflation compensation.

The bottom line is that it's hard to read today's statement as anything other than the Fed getting spooked by the recent employment report. Even Kansas City Fed Bank President Esther George, who voted to hike rates by 25 basis points in April, voted in favor of today's official statement.

We still think the Fed is headed for two rate hikes later this year, one in either July or September, and another in December. However, it now looks like September is a better bet than July and, given how easily and often the Fed has been spooked by economic reports and market fluctuations in the past several years, it's plausible they won't raise rates again until 2017.

But a slower path for rate hikes is not good for the US economy. Overly loose monetary policy will create financial and economic imbalances that will cost the economy in the long run.

The economy can handle higher short-term rates. The unemployment rate is already below the Fed's long-term projection of 4.8% and nominal GDP growth – real GDP growth plus inflation – is up at a 3.6% annual rate in the past two years. Slightly higher short-term interest rates are not going to derail the US expansion, but will help avoid the misallocation of capital that's inevitable if short-term rates remain artificially low.

Brian S. Wesbury, *Chief Economist*
Robert Stein, *Dep. Chief Economist*

Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in April indicates that the pace of improvement in the labor market has slowed while growth in economic activity appears to have picked up. Although the unemployment rate has declined, job gains have diminished. Growth in household spending has strengthened. Since the beginning of the year, the housing sector has continued to improve and the drag from net exports appears to have lessened, but business fixed investment has been soft. Inflation has continued to run below the Committee's 2 percent longer-run objective, partly reflecting earlier declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation declined; most survey-based measures of longer-term inflation expectations are little changed, on balance, in recent months.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will *expand at a moderate pace and labor market indicators will strengthen. Inflation is expected to remain low in the near term, in part because of earlier declines in energy prices, but to rise to 2 percent over the medium term as the transitory effects of past declines in energy and import prices dissipate and the labor market strengthens further. The Committee continues to closely monitor inflation indicators and global economic and financial developments.*

Against this backdrop, the Committee decided to maintain the target range for the federal funds rate at 1/4 to 1/2 percent. The stance of monetary policy remains accommodative, thereby supporting further improvement in labor market conditions and a return to 2 percent inflation.

In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to 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. In light of the current shortfall of inflation from 2 percent, the Committee will carefully monitor actual and expected progress toward its inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run. However, the actual path of the federal funds rate will depend on the economic outlook as informed by incoming data.

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, and it anticipates doing so until normalization of the level of the federal funds rate is well under way. This policy, by keeping the Committee's holdings of longer-term securities at sizable levels, should help maintain accommodative financial conditions.

Voting for the FOMC monetary policy action were: Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Lael Brainard; James Bullard; Stanley Fischer; Esther L. George; Loretta J. Mester; Jerome H. Powell; Eric Rosengren; and Daniel K. Tarullo.