First Trust ECONOMIC RESEARCH REPORT
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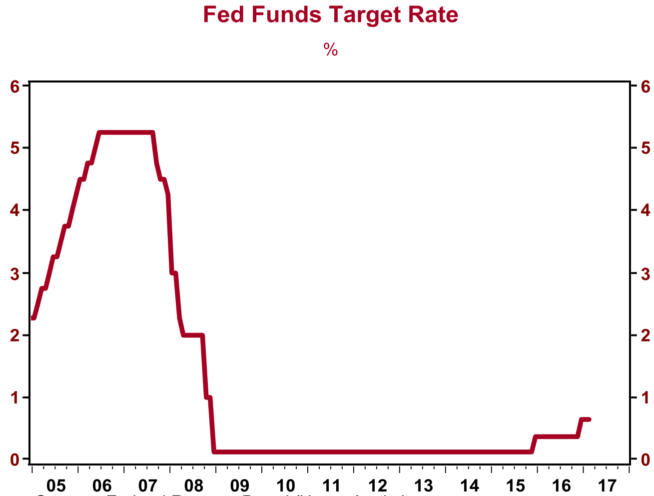
Fed Tilts Hawkish

After hiking rates in December, the chances of another rate hike from today's meeting were close to nil. But where changes, mostly modest, were made to today's statement, they point to a more hawkish stance.



Source: Federal Reserve Board /Haver Analytics

You can ignore the wording change to the language focused on economic growth and employment gains, but recent data seems to have boosted the Fed's confidence that inflation is moving towards their 2% target. The Fed made two noticeable changes when discussing inflation: 1) language regarding the impacts from energy and trade prices holding down inflation were removed, and more importantly 2) the Fed changed language from "inflation is expected to rise" to "inflation will rise" to 2% over the medium term. As we pointed out in this week's Monday Morning Outlook, average gains of 0.2% per month for the January and February readings are all that are required for the PCE index – the Fed's favored measure of inflation – to hit 2% year-to-year growth. To put that in perspective, the PCE index has shown gains of 0.2% or more in four of the last five months.

Today's statement also added language noting improvement in consumer and business sentiment in recent months. Why add this language when it hasn't been a focus in the past? If the data releases since the last Fed meeting are any indication, this confidence is leading to a pickup in business activity meaning more jobs and increased demand for goods. And given an unemployment rate already below the Fed's identified long-run target level, continued job gains point to higher wages and rising consumer spending.

All eyes will now be on the next Fed meeting in March. While some may argue that today's meeting didn't set the stage for a March hike, the hawkish tone will likely turn some heads. At a minimum, the economic projections and press conference accompanying the next Fed meeting should provide a clear picture on when the next rate increase will occur.

We expect the Fed will raise rates 3-4 times in 2017, starting in June if not before. This pace of hikes is in-line with the "dot plot" projections the Fed released in December. Economic fundamentals warrant higher rates, and the Fed would have been justified to raise rates today. The economy can handle higher short-term rates. Employment remains healthy and nominal GDP – real GDP growth plus inflation – has grown at a 3.2% annual rate in the past two years. Moreover, we are seeing signs of accelerating inflation. "Core" consumer prices are up 2.2% versus a year ago, tied with the largest increase since 2008, while average hourly earnings are up 2.9% from a year ago, despite many highly paid and productive Baby Boomers exiting the workforce.

Slightly higher short-term rates are not going to derail US growth, but will help avoid the misallocation of capital that's inevitable if short-term rates remain artificially low.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in December indicates that the labor market has continued to strengthen and that economic activity has continued to expand at a moderate pace. Job gains remained solid and the unemployment rate stayed near its recent low. Household spending has continued to rise moderately while business fixed investment has remained soft. Measures of consumer and business sentiment have improved of late. Inflation increased in recent quarters but is still below the Committee's 2 percent longer-run objective. Market-based measures of inflation compensation remain low; most survey-based measures of longer-term inflation expectations are little changed, on balance.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, labor market conditions will strengthen somewhat further, and inflation will rise to 2 percent over the *medium term. Near-term risks to the economic outlook appear roughly balanced. The Committee continues to closely monitor inflation indicators and global economic and financial developments.*

In view of realized and expected labor market conditions and inflation, the Committee decided to maintain the target range for the federal funds rate at 1/2 to 3/4 percent. The stance of monetary policy remains accommodative, thereby supporting some further strengthening 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; Charles L. Evans; Stanley Fischer; Patrick Harker; Robert S. Kaplan; Neel Kashkari; Jerome H. Powell; and Daniel K. Tarullo.