First Trust
ECONOMIC RESEARCH REPORT

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Economist*

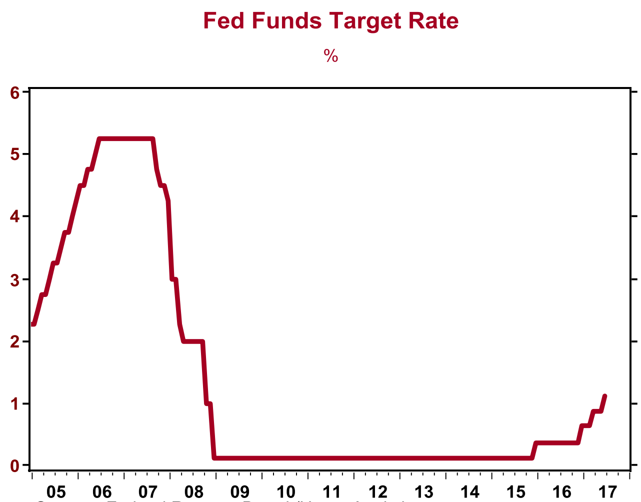
June 14, 2017 • 630.517.7756 • www.ftportfolios.com

Fed Hikes Again, Sets Plan to Re-Normalize Balance Sheet

The Federal Reserve did what almost everyone expected today, raising the target range for the federal funds rate by 25 basis points to 1.00% - 1.25%.

Here are the key takeaways from today's statement from the Fed, its updated forecasts, its plan on reducing the balance sheet, as well as Fed Chief Yellen's press conference.

First, although the market consensus is that the Fed isn't going to raise rates again until 2018, the Fed thinks we still have one more hike in 2017, with the odds of two hikes equal to the odds of none at all.



Source: Federal Reserve Board /Haver Analytics

Second, the Fed has a concrete plan to start reducing the size of its bloated balance sheet, a plan it is likely to start later this year. Once implemented, for the first three months, the Fed will reduce its balance sheet by $10 billion per month ($6 billion in Treasury securities, $4 billion in mortgage-related securities). Then, every three months, the amount of monthly balance sheet reduction will rise by $10 billion (w/ the same 60/40 proportion between Treasury securities and mortgage-related securities). That escalation will continue until the Fed is cutting its balance sheet by $50 billion per month.

Third, compared to three months ago, the Fed is expecting a little more economic growth this year, less unemployment, and less inflation. However, projections for economic growth and inflation remain unchanged beyond this year. The only significant change in the forecast was that the Fed now thinks the jobless rate will average 4.2% in 2018-19 instead of 4.5%. In addition, the Fed thinks the long run average rate for unemployment is 4.6% versus a prior estimate of 4.7%.

Fourth, the Fed is not impressed by the recent softness in inflation and does not think that softness is a reason to change the projected path of monetary policy. Although the Fed acknowledges inflation has receded back below its 2% target and is "monitoring inflation developments closely," it thinks inflation will head back to 2% in the medium term.

Fifth, the Fed is no longer as concerned about the potential negative influence of foreign events, having removed language saying it was closely monitoring "global economic and financial developments."

We still think the most likely path is that the Fed makes no policy changes in July but then uses the September meeting to make its last interest rate hike of the year while also announcing balance sheet reductions will start October 1. This is our interpretation of Yellen saying the balance sheet reductions would start "relatively soon." A less loose monetary policy than the market consensus believes is, in part, why we think long-term Treasury yields will be moving up significantly later this year, with a 3.00% target for the 10-year Treasury Note by the end of the year.

The most disheartening part of the today's Fed releases was that the plan for reducing the balance sheet noted that the Fed stands ready to use quantitative easing again in the future when the economy gets weak. We don't think QE helped the economy and had been hoping the Fed had learned that lesson. Apparently not.

Overall, however, we are pleased the Fed raised rates today and look forward to another rate hike and the beginning of balance sheet reductions later in 2017. Neither of these will hurt the economy and will help prevent future problems that could.

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 May indicates that the labor market has continued to strengthen and that economic activity has been rising moderately so far this year. Job gains have moderated but have been solid, on average, since the beginning of the *year, and the unemployment rate has declined. Household spending has picked up in recent months, and business fixed investment has continued to expand. On a 12-month basis, inflation has declined recently and, like the measure excluding food and energy prices, is running somewhat below 2 percent. Market-based measures of inflation compensation remain low; 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 continues to expect that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace, and labor market conditions will strengthen somewhat further. Inflation on a 12-month basis is expected to remain somewhat below 2 percent in the near term but to stabilize around the Committee's 2 percent objective over the medium term. Near term risks to the economic outlook appear roughly balanced, but the Committee is monitoring inflation developments closely.

In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 1 to 1-1/4 percent. The stance of monetary policy remains accommodative, thereby supporting some further strengthening in labor market conditions and a sustained 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. The Committee will carefully monitor actual and expected inflation developments relative to its symmetric inflation goal. The Committee expects that economic conditions will evolve in a manner that will warrant 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. The Committee currently expects to begin implementing a balance sheet normalization program this year, provided that the economy evolves broadly as anticipated. This program, which would gradually reduce the Federal Reserve's securities holdings by decreasing reinvestment of principal payments from those securities, is described in the accompanying addendum to the Committee's Policy Normalization Principles and Plans.

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; and Jerome H. Powell. Voting against the action was Neel Kashkari, who preferred at this meeting to maintain the existing target range for the federal funds rate.