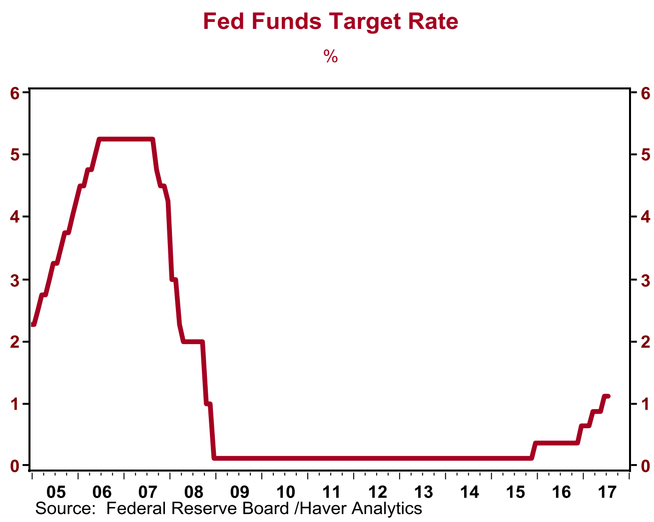
First Trust
ECONOMIC RESEARCH REPORT
Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Economist*
July 26, 2017 • 630.517.7756 • www.ftportfolios.com

The Road to Normal Starts in September

The Federal Reserve made no changes to interest rates today and made almost no changes to the text of its statement. However, the wording changes it did make strongly support our view the Fed will announce the start of balance sheet reductions at the end of its next meeting on September 20.

First, the Fed qualified its reference to maintaining its current policy of rolling over principal payments by saying this was the policy only for the "time being."

Second, at the last meeting in June, the Fed said renormalization would start "this year." Now it says "relatively soon," the same language Fed Chief Yellen used at the press conference (but not the Fed's official statement) back in June.



Third, back in June the Fed said it "currently" expected to start renormalizing the balance sheet. That left the Fed wiggle room to change its own expectation, as if it anticipated the possibility of making a change to its timing. Now, by removing "currently," the Fed is essentially saying the likelihood of changing its mind is much lower.

Put it all together and it looks like an announcement about renormalization is very likely to happen at the next meeting. Moreover, there were no dissents at all from today's statement, unlike in June, when Minneapolis President Neel Kashkari made a dovish dissent.

We expect the Fed's September announcement about renormalization to follow the path suggested in June. For the first three months (presumably, October – December) 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 (with 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 (presumably in the last quarter of 2018).

Meanwhile, the Fed softened language surrounding inflation expectations, but made it clear they still anticipate inflation moving towards their 2% inflation target over the medium term. Given the continued improvements in the labor market and consistent – if modest - inflation, we still anticipate the Fed will raise rates once more in 2017. That may change as markets react to the balance sheet normalization process and additional economic data, but, unlike many in the market, we place the odds of a December rate hike at well over 50%.

While others fret about renormalization and rising rates damaging the economy or financial markets, investors should remain bullish. Look for faster economic growth and a continuation of the bull market in equities in the years ahead.

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 June indicates that the labor market has continued to strengthen and that economic activity has been rising moderately so far this year. Job gains have been solid, on average, since the beginning of the year, and the unemployment rate has declined. Household spending and business fixed investment have continued to expand. On a 12-month basis, overall inflation and the measure excluding food and energy prices have declined and are running 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 maintain the target range for the federal funds rate at 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.

For the time being, 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 expects to begin implementing its balance sheet normalization program relatively soon, provided that the economy evolves broadly as anticipated; this program is described in the June 2017 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; Neel Kashkari; and Jerome H. Powell.