First Trust
ECONOMIC RESEARCH REPORT

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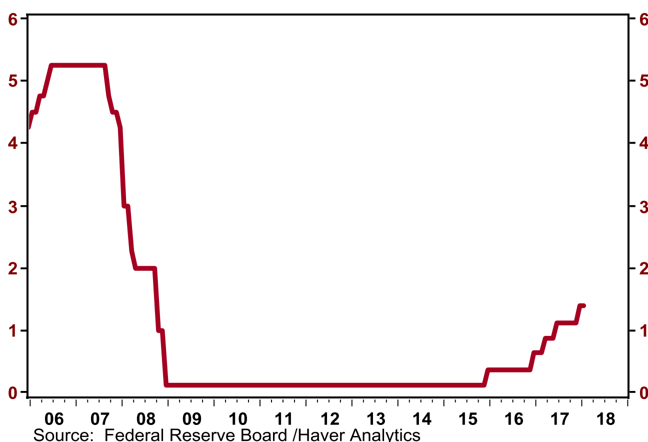
January 31, 2018 • 630.517.7756 • www.ftportfolios.com

Little Change as Yellen Exits

In Janet Yellen's swan song as Chair of the Federal Reserve, she exited on a quiet note. The Federal Reserve did what just about everyone expected earlier today, keeping short-term interest rates unchanged while providing forward guidance that economic growth remains on track for further hikes in 2018. The federal funds rate remains in a range from 1.25 - 1.50% and the Fed continues to pay banks 1.50% on their reserve balances.

The primary changes in the language of today's statement reflect increased confidence that inflation is moving towards the Fed's 2% target. While the December statement noted that inflation was "expected to remain below 2% in the near term", the Fed now expects inflation to "move up this year and stabilize around the Committee's 2 percent objective in the medium term."



Source: Federal Reserve Board /Haver Analytics

In addition, language related to fluctuations in hurricane-impacted data in late 2017 has been removed, with the focus shifted to the current "solid" growth in employment, household spending, business fixed investment, and overall economic activity.

In our view, monetary policy remains too loose and the economy can handle higher short-term rates. Nominal GDP (real GDP growth plus inflation) is up 3.9% per year in the past two years, leaving plenty of room for more rate hikes in 2018-19.

Taken as a whole, today's statement should serve to reinforce market expectations for three rate hikes in 2018, with the chances of a fourth rate hike higher than the chances of seeing just two.

In the meantime, the Fed will begin reducing its balance sheet at a pace of up to $20 billion per month (up from a $10 billion monthly pace in the fourth quarter of 2017), increasing that to $30 billion in Q2, $40 billion in Q3, and $50 billion in Q4. After that, the Fed is projecting it would maintain that $50 billion monthly pace until it's satisfied with the size of the balance sheet. (For the foreseeable future, the balance sheet cuts would be 60% in Treasury securities and 40% in mortgage-related securities.)

Starting in early February, current Fed Governor Jerome Powell will take the reins as Fed Chairman, but don't expect much change in policy or guidance. While Janet Yellen oversaw the ending of QE3, the start to rate hikes, and began the process of balance sheet normalization, the new Chairman is likely to simply continue the slow-but-steady process of making monetary policy less loose.

All eyes now shift to the next meeting in March, when the Fed is expected to raise rates. But more importantly, the FOMC members will also be releasing their latest economic projections (the Fed "dot plots") which will incorporate expected impacts from the tax cuts passed into law late last year. With continued economic growth and an improved outlook in the projections, we wouldn't be surprised to see markets shift up their expectations for the pace of rate hikes in 2018.

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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 been rising at a solid rate. Gains in employment, household spending, and business fixed investment have been solid, and the unemployment rate has stayed low. On a 12-month basis, both overall inflation and inflation for items other than food and energy have continued to run below 2 percent. Market-based measures of inflation compensation have increased in recent months but 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 expects that, with further gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market conditions will remain strong. Inflation on a 12 - month basis is expected to move up

this year and 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 1-1/4 to 1 - 1/2 percent. The stance of monetary policy remains accommodative, thereby supporting strong 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 further 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.

Voting for the FOMC monetary policy action were Janet L. Yellen, Chair; William C. Dudley, Vice Chairman; Thomas I. Barkin; Raphael W. Bostic; Lael Brainard; Loretta J. Mester; Jerome H. Powell; Randal K. Quarles; and John C. Williams..

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