First Trust ECONOMIC RESEARCH REPORT

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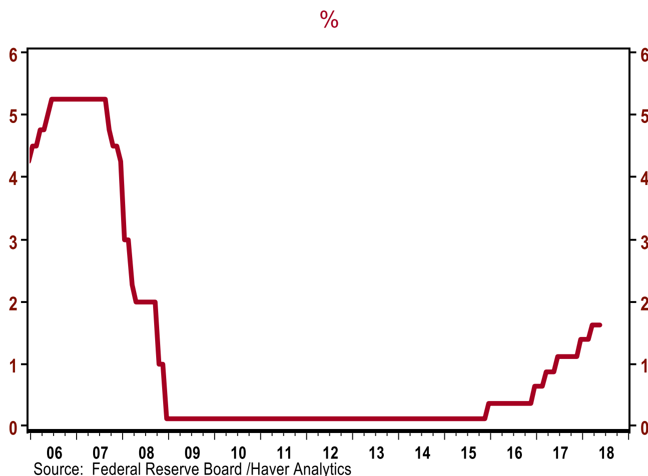
Letting the Data do the Talking

To little surprise, the Federal Reserve hiked interest rates by 25 basis points following today's meeting. Of much greater note are the hawkish changes made to the text of the Fed's statement (and with no dissents), as well as changes in the forecast materials. While these changes are clearly in line with the continued improvement in economic data over recent months, it's a positive development from a Fed that has been exceedingly cautious over recent years in upgrading its outlook on the pace of rate hikes.



Starting with the text of the Fed statement, stronger language related to rising economic activity and the continued decline in the unemployment rate was paired with the removal of long-standing language that noted the below-target inflation we have seen over recent years. Looking forward, language on "adjustments" to monetary policy have now become "increases…consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective".

A look at the updated projection materials (the dot plots) gives some insight in why the wording changes were made. The Fed's real GDP growth forecast was revised higher to 2.8% for 2018 (we expect growth will be at or above 3% this year, the fastest annual growth since 2005) - up from 2.7% in March and 2.5% at the December 2017 meeting – though projections remained unchanged for both 2019 and 2020. Inflation forecasts also moved higher for 2018, to 2.1% from 1.9%, and is expected to remain at 2.1% through 2020. The forecast unemployment rate was revised lower for 2018 to 3.6% from a previous forecast of 3.8%, while both 2019 and 2020 now show forecast unemployment of 3.5%, down from 3.6%. So across to board, changes point to improved economic conditions that justify higher rates.

During the press conference, Chairman Powell took time to reiterate, on multiple occasions, the strength of both the economy and the labor market. And when asked about concerns the Fed has related to recent trade and tariff talk, we were glad to hear that they will let the data do the talking. In other words, don't expect harrowing headlines or doomsday scenarios from the pouting pundits to change the Fed's outlook. As with so many other events over recent years, levels of media coverage are a very poor predictor of actual impact when the day is done.

That brings us, finally, to the Fed's projections for the pace of rate hikes. In March, there was a near even split between FOMC participants projecting three or fewer rate hikes in 2018, and those projecting four or more. While the shift is little changed on balance, the majority of members now expect two more rate hikes before the year is through, for a total of four. Markets, meanwhile, have come to the same conclusion, pricing in a 56% chance of two or more hikes over the remainder of 2018. Looking forward, the Fed still expects three 25 basis point rate hikes in 2019 (we expect four), with one more to follow in 2020. If that pace is realized, the Federal Funds rate will stand in a range of 3.25%-3.5% at the end of 2020, still below the 3.9% trend in Nominal GDP growth over the past five years, a sign that monetary policy won't be tight for the foreseeable future.

Almost missed in the focus on rates moving forward, the Fed will continue reducing its balance sheet at a pace of up to $30 billion per month, increasing that to $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.)

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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 at a solid rate. Job gains have been strong, on average, in recent months, and the unemployment rate has declined. Recent data suggest that growth of household spending has picked up, while business fixed investment has continued to grow strongly. On a 12-month basis, both overall inflation and inflation for items other than food and energy have moved close to 2 percent. Indicators 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 further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. Risks to the economic outlook appear roughly balanced.

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 1-3/4 to 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 maximum employment objective and its symmetric 2 percent inflation objective. 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.

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

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