First Trust ECONOMIC RESEARCH REPORT

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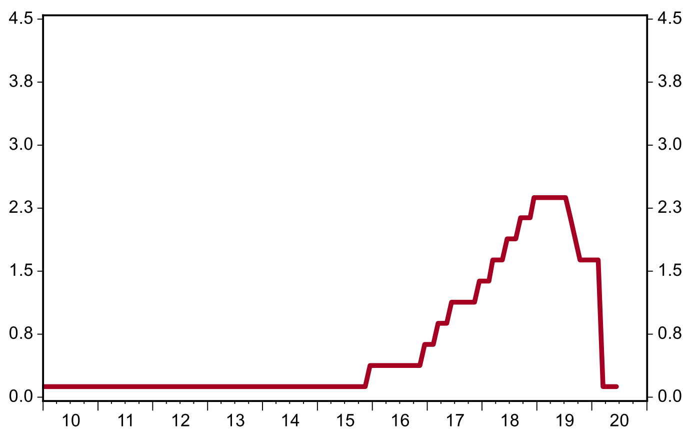
Loose and Staying Loose

The most important takeaway from today's Fed meeting is that policymakers don't expect to raise short-term interest rates until *at least* 2023.

The Federal Reserve's "dot plot" shows where policymakers think short-term interest rates will be at the end of this year, 2021, and 2022 and these show that no members of the rate setting committee – literally, none – think rates will go up this year or in 2021 and that only a small minority thinks they'll rise in 2022.

Moreover, the median estimate among policymakers is that the unemployment rate will finish 2022 at 5.5%. In the aftermath of the 2008-09 recession, the Fed didn't raise rates until December 2015, when the unemployment rate was 5.0%. As a result, we think it would be useful to follow the Fed's projections in the quarters ahead, using the 5.0 – 5.5% range as a proxy for when the Fed expects to start once again lifting short term rates. Notably, the Fed still projects that the average short-term interest rates target over the long run will be 2.5%, no different than it projected in December, before the Coronavirus Recession.



Source: Federal Reserve Board/Haver Analytics

The Fed's economic projections show a deep recession followed by above-trend growth thereafter as the economy heals, with no permanent damage to GDP. The longer run unemployment rate is still projected at 4.1%, no different than in December. Inflation, the Fed projects, will be very low this year and then move back toward, although remain below, its 2.0% target in 2021-2022.

The Fed statement itself, which was unanimous, made only two notable changes. First, it acknowledged an improvement in financial conditions. Second, it said it would keep buying Treasury securities and agency residential and commercial mortgage-backed securities at "at least" the current pace. So no slowdown in the expansion in the Fed's balance sheet.

Does this loose monetary policy mean higher inflation? Yes, but not right away. We think the immediate deflationary impulse from the sudden sharp recession and drop in commodity prices is likely over. General prices should start rising again soon. But the rise in inflation will depend on how quickly the economy recovers, how fast consumers and businesses back away from the demand to conserve cash, and how quickly the Fed recognizes these changes by altering the pace of asset purchases. In the past three months, because of this new QE, the M2 measure of money has grown 86% at an annualized rate. We know of no time in history when the money supply increased this rapidly. So, while we expect inflation to return slowly, the "potential" for relatively high inflation is greater than at any time since the 1970s. In other words, the jury is still out on how quickly inflation rises during the next couple of years.

Looking forward, expect more of the same in 2020: continued expansion of their balance sheet and short-term rates near zero.

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Text of the Federal Reserve's Statement:

The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals.

The coronavirus outbreak is causing tremendous human and economic hardship across the United States and around the world. The virus and the measures taken to protect public health have induced sharp declines in economic activity and a surge in job losses. Weaker demand and significantly lower oil prices are holding down consumer price inflation. Financial conditions have improved, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.

The ongoing public health crisis will weigh heavily on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term. In light of these developments, the Committee decided to maintain the target range for the federal funds rate at 0 to 1/4 percent. The Committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.

The Committee will continue to monitor the implications of incoming information for the economic outlook, including information related to public health, as well as global developments and muted inflation pressures, and will use its tools and act as appropriate to support the economy. In determining the timing and size of future adjustments to the stance of monetary policy, 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.

To support the flow of credit to households and businesses, over coming months the Federal Reserve will increase its holdings of Treasury securities and agency residential and commercial mortgage-backed securities at least at the current pace to sustain smooth market functioning, thereby fostering effective transmission of monetary policy to broader financial conditions. In addition, the Open Market Desk will continue to offer large-scale overnight and term repurchase agreement operations. The Committee will closely monitor developments and is prepared to adjust its plans as appropriate.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michelle W. Bowman; Lael Brainard; Richard H. Clarida; Patrick Harker; Robert S. Kaplan; Neel Kashkari; Loretta J. Mester; and Randal K. Quarles.

This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.