First Trust
ECONOMIC RESEARCH REPORT
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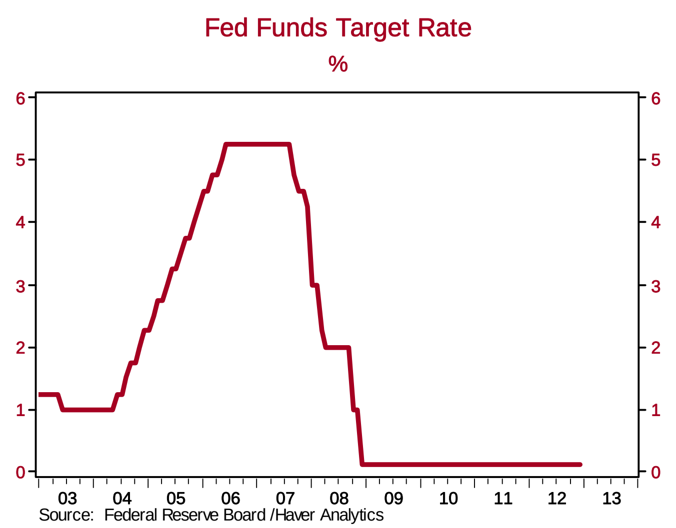
To QE Infinity, and Beyond!

The Federal Reserve made two big changes today, but changes that were mostly anticipated by the markets.

First, the Fed decided to convert Operation Twist into an outright expansion of its balance sheet. Since September 2011, the Fed has been buying $45 billion per month in long-term Treasury securities and, at the same time, selling $45 billion in short-term securities. Once this program ends at the end of December, the Fed will keep buying the long-term securities but stop selling the short-term ones.

This is not some cosmetic change. Unlike Operation Twist, which shifted the *composition* of the Fed's balance sheet (more long-term, less short-term), the new program will expand the *size* of the balance sheet. If the Fed does it for all of 2013, it will add about $540 billion to a balance sheet that is now $2.8 trillion. Meanwhile, the Fed will keep buying $40 billion per month in mortgage securities, so we're on a path for a balance sheet of nearly $4 trillion by the end of next year.



We don't like the change. The extra expansion of the Fed's balance sheet is not going to help the economy. The vast majority will simply add to excess reserves in a banking system that's already overstuffed with $1.4 trillion in excess reserves. Banks, knowing the Fed will eventually retract this liquidity are not eager to lend it out. When nominal GDP – real GDP plus inflation – is consistently growing at a 4%+ annual rate, a federal funds rate of nearly zero is unsustainably low. Monetary policy is already too loose. Policymakers need to focus on fiscal and regulatory obstacles to growth, not a supposed lack of monetary accommodation.

The second big change by the Fed is the removal of a specific timeframe for keeping rates at essentially zero. As recently as the October meeting, the Fed was saying it would keep rates at current levels through mid-2015. Instead, the Fed introduced economic guideposts to signal when it will start changing short term rates. These include an unemployment rate at or below 6.5%, an inflation *forecast* (by the Fed) of 2.5% or more, or an unmooring of inflation expectations. In addition, the Fed says it will also look at other measures of the labor market, inflation pressure, and the financial markets. Note that the Fed's most important inflation measure is its own projection of future inflation, not actual inflation. In other words, higher inflation, by itself, won't mean higher short term rates, unless the Fed thinks higher inflation will be persistent.

Notably, the Fed also issued a more pessimistic set of economic projections than it previously released in September, reducing the real GDP growth rate for 2012-15 by about 0.1 percentage points per year. Despite the fact that the unemployment rate in recent months has declined faster than the Fed anticipated, it thinks the jobless rate will end 2014 at *or slightly above* where it previously thought. Taking these projections at face value, as well as the Fed's projections for inflation, suggests the consensus view at the Fed is the federal funds rate will not have to rise until the third quarter of 2015. This is consistent with its previous guidance of staying where they are until at least mid-2015. By contrast, plugging the First Trust forecast of the unemployment rate into the Fed's framework suggests the first rate hike will come in the third quarter of 2014, about a year earlier than the Fed now anticipates.

Other, more minor, changes to the statement include the following.

(1) Adding an assessment of employment into the very first sentence of the statement, showing how focused the Fed is on the labor market.
(2) Removing a reference to the housing market coming back "from a depressed level," suggesting the Fed thinks the housing recession is getting further away in the rear view mirror and is less relevant to the economy today.
(3) Inserting a reference to monetary policy staying accommodative for a considerable period "after the asset purchase program ends." In other words, the Fed will stop expanding its balance sheet before it starts raising rates.

It also reiterated that it will "closely monitor" the economy and financial markets to gauge whether it should continue asset purchases or even expand them.

Once again, the lone dissent was from Richmond Fed President Jeffrey Lacker, who opposed both the asset purchase program and the economic guideposts chosen to signal when the Fed will consider raising interest rates.

Like we have been saying for many months, quantitative easing will simply keep adding to the already enormous excess reserves in the bank system, not deal with the underlying causes of economic weakness, including the growth in government spending, excessive regulation, and expectations of higher future tax rates. It will not add anything to economic growth and, as long as banks are reluctant to lend aggressively, not cause hyper-inflation either.

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Text of the Federal Reserve's Statement:

Information received since the Federal Open Market Committee met in October suggests that economic activity and employment have continued to expand at a moderate pace in recent months, apart from weather-related disruptions. Although the unemployment rate has declined somewhat since the summer, it remains elevated. Household spending has continued to advance, and the housing sector has shown further signs of improvement, but growth in business fixed investment has slowed. Inflation has been running somewhat below the Committee's longer-run objective, apart from temporary variations that largely reflect fluctuations in energy prices. Longer-term inflation expectations have remained stable.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee remains concerned that, without sufficient policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor market conditions. Furthermore, strains in global financial markets continue to pose significant downside risks to the economic outlook. The Committee also anticipates that inflation over the medium term likely will run at or below its 2 percent objective.

To support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee will continue purchasing additional agency mortgage-backed securities at a pace of $40 billion per month. The Committee also will purchase longer-term Treasury securities after its program to extend the average maturity of its holdings of Treasury securities is completed at the end of the year, initially at a pace of $45 billion per month. 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, in January, will resume rolling over maturing Treasury securities at auction. Taken together, these actions should maintain downward pressure on longer-term interest rates, support mortgage markets, and help to make broader financial conditions more accommodative.

The Committee will closely monitor incoming information on economic and financial developments in coming months. If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of Treasury and agency mortgage-backed securities, and employ its other policy tools as appropriate, until such improvement is achieved in a context of price stability. In determining the size, pace, and composition of its asset purchases, the Committee will, as always, take appropriate account of the likely efficacy and costs of such purchases.

To support continued progress toward maximum employment and price stability, the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens. In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. The Committee views these thresholds as consistent with its earlier date-based guidance. In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent.

Voting for the FOMC monetary policy action were: Ben S. Bernanke, Chairman; William C. Dudley, Vice Chairman; Elizabeth A. Duke; Dennis P. Lockhart; Sandra Pianalto; Jerome H. Powell; Sarah Bloom Raskin; Jeremy C. Stein; Daniel K. Tarullo; John C. Williams; and Janet L. Yellen. Voting against the action was Jeffrey M. Lacker, who opposed the asset purchase program and the characterization of the conditions under which an exceptionally low range for the federal funds rate will be appropriate.