First Trust
Monday Morning OUTLOOK

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – *Dep. Chief Economist*
Strider Elass – *Senior Economist*
Andrew Opdyke, CFA – *Economist*
Bryce Gill – *Economist*

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The Fed is Committed to Low Rates

The one key takeaway from last week's Fed meeting is that monetary policymakers are set to keep short-term interest rates near zero for as far as the eye can see. Not forever, but at least until 2023. Keep this in mind in the week ahead, as we get more reports confirming the economic recovery started back in May.

The Federal Reserve conveyed that commitment in a few different ways. First, and most important, was the quote from Wednesday's post-meeting press conference with Fed Chairman Jay Powell that the Fed is not even "thinking about thinking about raising rates." In other words, raising rates is not even on their radar.

Second, the "dot plots," which show how many Fed officials think short-term interest rates will finish at various levels in the next few years, showed that not a single one of the seventeen officials offering a forecast thinks there will be a rate hike this year or next. Only two of the seventeen think there will be a rate hike in 2022.

Third, the Fed's economic forecast shows they think the unemployment rate will finish 2022 at 5.5%. That's important because in the aftermath of the Financial Crisis in 2008-09, the Fed didn't raise short-term interest rates again until December 2015, when the jobless rate had fallen to 5.0%. At present the Fed expects the unemployment rate to finish this year at 9.3%, next year at 6.5%, and 2022 at 5.5%. So, if the Fed's forecast for the unemployment rate is right, and it stays consistent with how it reacted coming out of the last recession, that suggests it would not be raising rates until mid-2023.

However, there is also the possibility that the Fed waits even longer to raise rates this time around, or, if it starts at a similar point (5.0% unemployment), might raise rates even more slowly than it did in the prior cycle.

The Fed's favorite measure of inflation is the personal consumption expenditure (PCE) deflator. From the peak in the business cycle in December 2007, through the peak in the most recent expansion in February 2020, the PCE deflator increased at an average annual rate of 1.5%. From the bottom of the recession in June 2009, through the bottom of the recent recession in May 2020, we estimate that the PCE deflator rose at a 1.4% annual rate.

Either one you pick – peak-to-peak or trough-to-trough – the deflator averaged less than the 2.0% level the Fed has repeatedly said is its long-term target for average inflation. Moreover, Fed statements have been asserting that its 2.0% inflation target is "symmetric," which means the Fed wants to see inflation be above 2% as much as it is below 2.0%.

Given all this, we think the Fed would like to see inflation run higher than it did in the prior economic expansion and will be even more hesitant to raise interest rates. They will err on the side of too much inflation, rather than too little.

The good news is that the Fed seems reluctant to adopt two other policy tools, both of which we believe would be major mistakes. The first tool, negative interest rates, are essentially a tax on the financial system, and tend to embed expectations of weak GDP growth in the countries that have tried them.

The second tool, "yield curve control," has the Fed committing to keeping medium- or longer-term interest rates at or below a certain level. For example, the Fed could commit to making sure the yield on the 5-year Treasury Note is at or below 0.35%, buying potentially unlimited amounts of Treasury debt to target that goal. The problem with yield curve control, is that it decimates price signals coming from the Treasury market, substituting centralized monetary planners' judgements for the collective wisdom of the free market.

In the meantime, this week's reports should show that the economy was healing before the Fed's meeting. Retail sales, industrial production, and housing starts should all be up sharply for May, and we expect a continued decline in claims for unemployment insurance, as well. We are still a long way off from being fully recovered, but the process has to start somewhere. In May, the recovery began.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-15 / 7:30 am	Empire State Mfg Survey – Jun	-30.0	**-35.0**	-0.2	-48.5
6-16 / 7:30 am	Retail Sales – May	+8.0%	**+9.0%**		-16.4%
7:30 am	Retail Sales Ex-Auto – May	+5.3%	**+6.5%**		-17.2%
8:15 am	Industrial Production – May	+3.0%	**+2.8%**		-11.2%
8:15 am	Capacity Utilization – May	66.9%	**66.9%**		64.9%
9:00 am	Business Inventories – Apr	-1.0%	**-1.3%**		-0.2%
6-17 / 7:30 am	Housing Starts – May	1.100 Mil	**1.100 Mil**		0.891 Mil
6-18 / 7:30 am	Initial Claims – Jun 13	1.290 Mil	**1.290 Mil**		1.542 Mil
7:30 am	Philly Fed Survey – Jun	-25.0	**-35.0**		-43.1

Consensus forecasts come from Bloomberg. 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.