Fed Doesn't Budge

May 2, 2013

by Brian Wesbury, Bob Stein of First Trust Advisors

It would be hard to find a policy statement from the Federal Reserve with as few changes as the one issued today. The Fed made no changes to monetary policy and only minor changes to the language of its statement. Even the lone dissent, from Kansas City Fed Bank President Esther George, was a carbon copy from the last statement in March.

On the economy itself, the Fed added a few words suggesting a more tepid recovery in the labor market, consistent with last month's report of softer growth in payrolls. The Fed also suggested more confidence that fiscal policy is restraining economic growth. We think this confidence is misplaced. The Fed, which is often obsessed with the "wealth effect" from the stock market, ignored that the S&P 500 was up 5.5% since the federal spending sequester went into effect. That's more than $500 billion in household wealth. Applying a modest 5% propensity to consume out of this wealth, suggests added spending of $25 billion, more than half of the total sequester-related spending cuts through the end of September.

On monetary policy, the Fed added a sentence saying that it "is prepared to increase or reduce the pace of (asset) purchases…as the outlook for the labor market or inflation changes." Others might make a big deal out of this, but we think it is not a shift in policy at all. By now, every investor should have known that the Fed, which is already on its third round of quantitative easing, might increase asset purchases if they don't get the data they want to see.

As we have written many times before, QE3 is simply adding to the already enormous excess reserves in the banking system, not dealing with the underlying causes of economic weakness, including the growth in government, excessive regulation, and expectations of higher future tax rates. QE3 will not add anything to economic growth and, as long as banks are reluctant to lend aggressively, not cause hyper-inflation either.

Nominal GDP – real GDP plus inflation – is already growing at around a 3.5% annual rate. At that pace, the economy can already sustain a much higher federal funds rate than now prevails. Maintaining rates near zero percent will eventually lead to inflation running consistently above the Fed's 2% target, which means once it starts raising rates the peak will be higher than 4%, perhaps much higher.

This information contains forward-looking statements about various economic trends and strategies. You are cautioned that such forward-looking statements are subject to significant business, economic and competitive uncertainties and actual results could be materially different. There are no guarantees associated with any forecast and the opinions stated here are subject to change at any time and are the opinion of the individual strategist. Data comes from the following sources: Census Bureau, Bureau of Labor Statistics, Bureau of Economic Analysis, the Federal Reserve Board, and Haver Analytics. Data is taken from sources generally believed to be reliable but no guarantee is given to its accuracy.

www.ftportfolios.com