LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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FED PREVIEW: CONNECT THE DOTS

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KEY TAKEAWAYS

The Fed is widely expected to raise rates for the second time this year at the conclusion of its policy meeting on Wednesday.

Markets will be focusing on changes to the Fed's policy statement, new economic projections, and Fed Chair Powell's press conference to gauge the future path of rates.

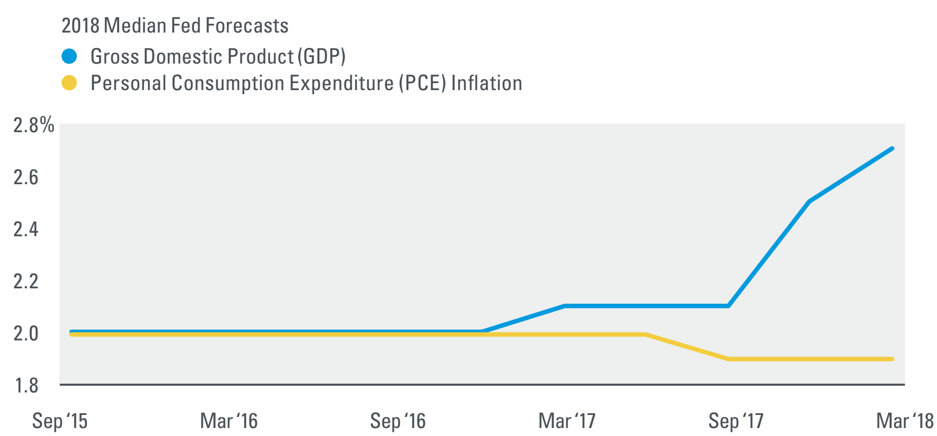
With unemployment low, the Fed's inflation outlook is playing an increasingly central role in policy expectations.

The Federal Reserve (Fed) is widely expected to hike rates for the second time in 2018 at the conclusion of its two-day policy meeting on Wednesday, June 13. Given that the hike is all but priced in, the hike itself would mean little to markets. Instead, Fed watchers will be looking at any meaningful changes in the policy statement, a new set of economic projections, and Chair Jay Powell's post-meeting press conference to gauge any changes to the future path of interest rates. There's a reasonable chance that the median expectation for the number of rate hikes in 2018 in the new projections may shift from three to four, but we believe it's more important to monitor any changes in the Fed's inflation views to determine the likelihood that the Fed may shift to a more aggressive path of rate hikes. Unless we see a shift in the Fed's view of inflation, we will continue to maintain a base case of three total rate hikes in 2018.

GROWTH FORECASTS LEAVING INFLATION BEHIND, FOR NOW

Every second Fed meeting is accompanied by a set of economic projections, made individually by the 7 members of the Fed Board of Governors and the 12 regional Federal Reserve Bank presidents. Over the last several sets of projections, 2018 growth forecasts have climbed meaningfully, while inflation forecasts have remained stable [Figure 1]. For the Fed, this is a "Goldilocks" economy, in which we have solid economic growth but inflation remains contained, allowing the Fed to move

1 FED'S 2018 GROWTH FORECASTS HAVE RISEN BUT INFLATION FORECASTS HOLDING STEADY



Source: LPL Research, Federal Reserve, Bloomberg 06/08/18

Forecasts may not develop as predicted.

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gradually toward a more neutral policy stance while still fulfilling its dual mandate of maintaining maximum sustainable employment and low and stable inflation.

As of the last set of projections, made in March, median expectations for growth in 2018 (+2.7%), 2019 (+2.4%), and 2020 (+2.0%) were all above the longer-run growth rate of 1.8%. Similarly, expectations for the unemployment rate in 2018 (3.8%), 2019 (3.6%), and 2020 (3.6%) were well below the expected longer-run rate of 4.5%. Clearly, the economy is at or above maximum sustainable employment and the Fed has no more work to do here. However, the Fed believes it has had leeway to tighten policy gradually, avoiding a shock to the economy, due to inflation expectations for 2018 (1.9%), 2019 (2.0%), and 2020 (2.1%) that remain in line with longer-run expectations (2.0%).

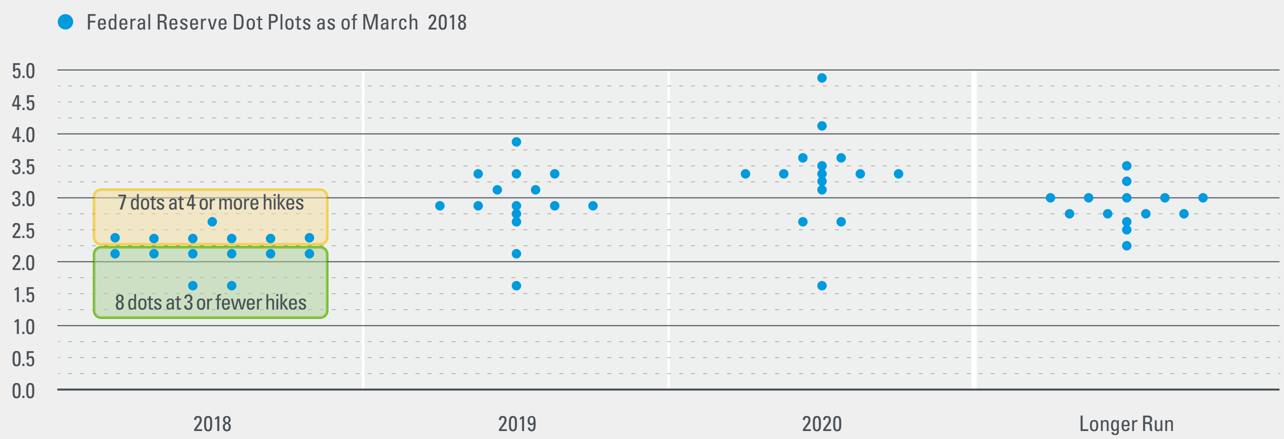
Since the economy is meeting the goal of maximum sustainable employment, the key to Fed policy is now inflation. As reflected in their inflation expectations, Fed members do not see meaningful inflationary pressures over the next several years. Several risk factors, however, need to be monitored, primarily the possibility that a tightening labor market could start to create additional wage pressures, in addition to the potential impact of trade policy. Neither of these is creating a meaningful shift in expectations to date, and even modest pressures would be manageable, allowing the economy to potentially stay in the Goldilocks zone for an extended period. But even if that is our base case, inflation risks lean to the upside. Market participants are aware of these risks and will be carefully watching for any signs that the Fed sees inflation risks increasing.

CONNECTING THE DOTS

One of the data points that gets the most attention is the median dot in the "dot plots," the projections for expected interest rates at the end of 2018, 2019, and 2020 and in the longer run. There would usually be 19 dots, each representing an individual view, although transitions or turnover can temporarily lower the number. The March numbers, for example, had 15 individual projections. The median projection is just the individual forecast that's in the middle. A simpler idea than an average, the median provides a more straightforward way of characterizing which forecast is most typical for the entire set.

In the last set of forecasts, eight of the forecasts projected three rate hikes or fewer in all of 2018; seven forecasts projected four or more [Figure 2].

2 FOLLOW THE DOTS —WILL 2018 MEDIAN MOVE TO FOUR HIKES?



Source: Federal Reserve 06/08/18

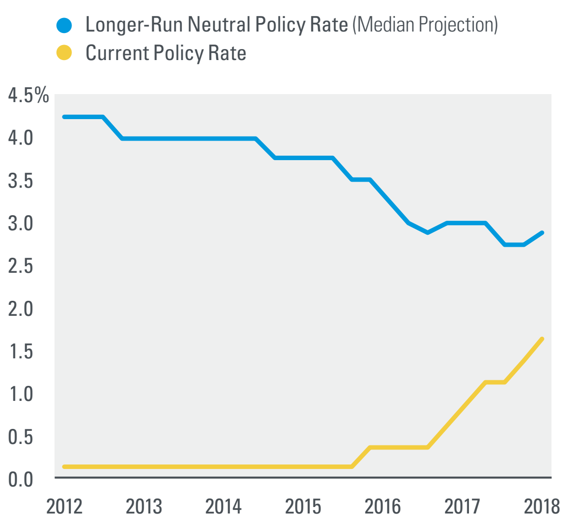
*The 2.0–2.25% range in 2018 represents three expected hikes. Rate-hike expectations may not develop as predicted.

That put the median at three hikes. But it also meant that just one dot is needed to move from three or fewer to four or more for the median to shift. Practically speaking, the shift of a single projection shouldn't matter that much, but because the median gets a fair amount of media attention, a shift may play an outsized role in creating a perception that the Fed is getting more aggressive. A shift in the median should be meaningful only if the broader context of the policy statement, Powell's press conference, and the other forecasts provide supporting evidence of a potentially more aggressive path of rate hikes, especially if accompanied by changing views on inflation. In isolation, its impact should probably be discounted.

FINDING NEUTRAL

The minutes from the last policy meeting noted the opening of a discussion around a fundamental change that will need to be made in the post-meeting policy statement at some future meeting. The policy statement currently includes language emphasizing expectations that the policy rate would run below longer-run rates "for some time" and that "the stance of monetary policy remains accommodative." While unlikely to happen at this meeting, and probably not at the next several, recognition that policy had moved from accommodative to something closer to neutral would mark a watershed moment in the most extended period of accommodative monetary policy in the history of the institution. Although we believe the torch has already been passed from monetary policy (the Fed) to fiscal policy (Congress and executive action) as the lead in determining how government policy shapes the economy, the Fed's explicit acknowledgement of the shift could impact markets.

3 POLICY RATE CONVERGING ON THE PROJECTED LONGER-RUN NEUTRAL RATE



Source: LPL Research, Federal Reserve, Bloomberg 06/08/18

To provide some context for when this might take place, Figure 3 looks at the median Fed forecast for the longer-run neutral policy rate compared with the actual policy rate. The projected longer-run neutral policy rate and the current rate have been converging from both directions. The longer-run neutral rate has been declining since the Fed started providing policy rate projections in January 2012, while the current policy rate has been rising since the first rate hike of the cycle in December 2015. The current spread, at 1.25%, still represents five quarter-point rate hikes, which would place expected convergence likely at some point in late 2019, but a neutral stance is better treated as a range than a single point, and the Fed and markets would probably view the range as wider to the downside when we're in a rising rate regime.

At some point, that convergence will be close enough for the Fed to no longer characterize its policy stance as accommodative. Even if we would not expect the language to change in the next several meetings, the fact that the timing has become part of the conversation means we're getting close. The shift would be more than simply symbolic, and the Fed will likely start rolling out an evolving communication strategy to prepare markets for the change. After years of extraordinary policy, the Fed is explicitly thinking about when it can call its stance neutral.

EUROPEAN CENTRAL BANK MEETING

The Fed is not the only central bank that will be garnering attention next week. The European Central Bank (ECB) will also be meeting, with a follow-up press conference by ECB Chair Mario Draghi, on Thursday, June 14. Markets will be watching for any signal that the ECB may be ready to end its bond purchase program. Baseline expectations are that there will be no announcement of a specific timeline, but that we'll get some confirmation that such an announcement may be likely at the next meeting, on July 26. There was some buzz that the announcement may come earlier than expected after ECB Chief Economist Peter Praet, who is responsible for proposing the policy change, highlighted the decision in a recent speech. But with first-quarter Eurozone growth unexpectedly slowing in the Eurozone and the brief market shock from political uncertainty in Italy, we believe the remarks may have been misinterpreted and Praet may have simply been preparing the markets for Draghi introducing the idea of an announcement in July. A formal announcement on Thursday of a target date for unwinding bond purchases would be market moving, potentially strengthening the euro, weakening the dollar, and pushing rates marginally higher, with some possible weakness in European equity markets.

CONCLUSION

With a rate hike all but priced in for the Fed's meeting this week, markets will be focused on changes in the policy statement, a new set of economic and policy forecasts, and Powell's post-meeting press conference. Our base case is that the Fed will maintain its current course and hike rates a total of three times in 2018. However, risks are increasingly to the upside and markets will be sensitive to any signs that the Fed may be considering a more aggressive, if still gradual, path of rate hikes or any change in its assessment of inflation. ■

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