December 3 2018

FED SHOWS FLEXIBILITY

John Lynch *Chief Investment Strategist, LPL Financial*
Barry Gilbert, PhD, CFA *Asset Allocation Strategist, LPL Financial*

KEY TAKEAWAYS

Recently, investors have been focused on the Fed's comments about the neutral rate.

We recommend investors trust the Fed's pragmatic approach to policy.

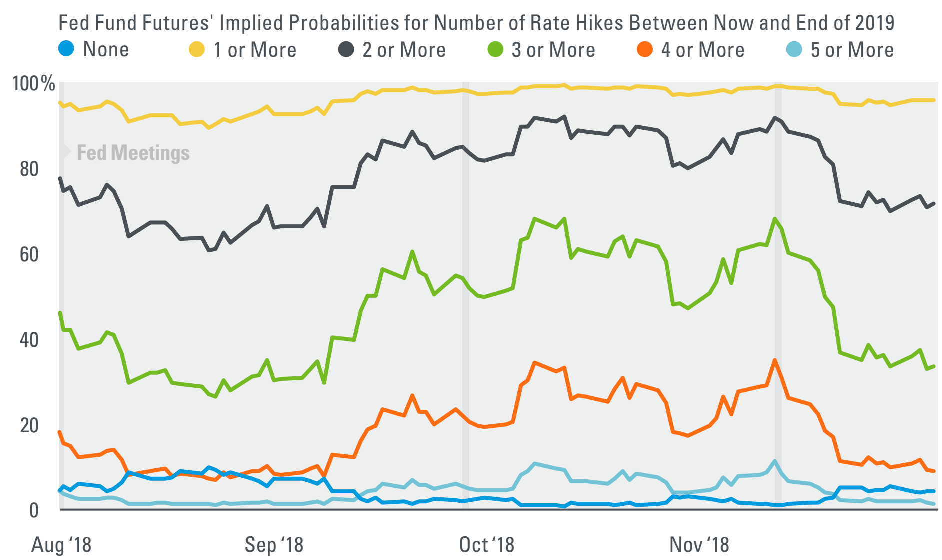
Fed fund futures are more dovish than the Fed's dots, but the Fed is treading carefully.

Last week, dovish language from the Federal Reserve (Fed) fueled one of the strongest rallies in U.S. stocks this year. On November 28, the S&P 500 Index posted its biggest daily gain since March and the U.S. dollar dropped the most in two weeks after Fed Chair Jerome Powell said current interest rates are "just below neutral," referring to the point where monetary policy is neither accommodative nor restrictive for the economy.

Powell's comments, along with Fed Vice Chair Richard Clarida's speech the day before, restored investors' confidence in the Fed's commitment to flexibility—a theme we've highlighted as Powell has increasingly emphasized a pragmatic approach to evaluating risks. That was the message investors needed to hear, especially in light of recent negative headlines about trade, geopolitical issues, and deteriorating economic data globally.

Over the past few weeks, market-based forecasts of the Fed's policy rate have been increasingly positioned for a slower path of rate hikes [Figure 1]. Fed fund futures' implied probability of at least three 25 basis point (0.25%) rate hikes between now and the end of next year has slipped to about 30% (from about

1 RATE HIKE EXPECTATIONS DROPPED IN NOVEMBER



Source: LPL Research, Bloomberg 11/29/18

The economic forecasts may not develop as predicted.

65% on November 8, the conclusion of the Fed's last meeting). Futures are pricing in an upper-bound fed funds rate of 2.7% for the end of 2019, even while pricing in an 80% probability of a rate hike at the December meeting. Essentially, futures traders are pointing to just one rate increase next year, assuming the Fed hikes rates later this month.

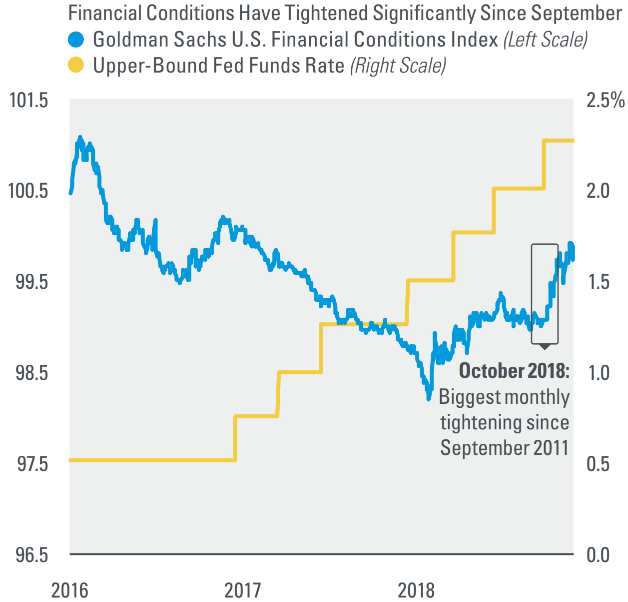
Investors are understandably anxious about the Fed's policy outlook, especially as economic headwinds have strengthened in recent weeks. However, we encourage investors to keep in mind the Fed's strategy of viewing monetary policy as pragmatically adaptable rather than theoretically fixed. The Fed has a loose target in mind at any given time and needs to provide guidance to markets, but it also will remain flexible about updating those views as new economic developments occur.

THE "POWELL PUT"

The neutral rate is a practical idea rather than a known macroeconomic variable, and it takes

2 MARKETS ARE DOING THE FEDERAL RESERVE'S WORK

Financial Conditions Have Tightened Significantly Since September



Source: LPL Research, Goldman Sachs, Bloomberg 11/29/18

a pragmatic policy approach to move toward the neutral rate while avoiding the risks of overtightening or leaving policy too loose. Still, the Fed's vague comments about the neutral rate have influenced the direction of financial markets recently. On October 3, Powell mentioned that interest rates are "a long way from neutral," even after repeating his standard view that the neutral rate is an uncertain target and the risks remain balanced. Markets processed that comment as excessively hawkish given current headwinds. In the weeks after that, the 10-year Treasury yield reached a 7-year high and the S&P 500 fell into a correction as investors prepared for quicker tightening. Last week, Powell effectively walked back his October comments, amplifying Clarida's earlier comments that rates were "much closer" to the neutral rate, sparking the strong rally in stocks.

Even though markets have reacted to the Fed's words, recent clues have shown that policymakers continue to base decision-making on the pragmatic evaluation of risks. In the minutes from the Fed's last meeting, policymakers discussed trade, deterioration in business-related economic data, the strong U.S. dollar's impact on overseas economies, and tightening financial conditions [Figure 2]. They debated the implications of a strengthening dollar on overseas economies, demonstrating the Fed's concern with global stability when determining the next steps for monetary policy. Policymakers also mentioned declining growth in business spending and acknowledged that trade uncertainty could hamper potential growth for U.S. corporations. Clarida echoed this in his most recent speech, saying a protracted slowdown in capital investment could eventually weigh on productivity increases. Most importantly, Fed members acknowledged in the minutes that they must better convey their flexibility to economic circumstances.

The Fed has telegraphed its own uncertainty around the neutral rate—a message that supports a cautious approach to policy decisions going forward. Both Powell and Clarida have publicly equated the evaluation of monetary policy steps to walking slowly in a dark room to avoid stubbing your toes. We interpret this message as a strong note of caution as policymakers tighten policy from ultra-accommodative levels in a unique and complex economic environment.

THE DOTS

What about the dots? To be fair, the Fed's "dot plot," a compilation of the Fed Board of Governors members' and Fed bank presidents' projected level of rates, telegraphs a more hawkish view of future policy. The dot plot, which was last updated in September, shows that members expect the fed funds rate to rise to a range of 3% to 3.25% at the end of 2019 (or four hikes from current rates), then peak at 3.25–3.5% at the end of 2020 before declining to a "longer term" rate of 3%. That "longer term" rate is investors' best gauge of the neutral rate based on the dots.

However, we encourage investors to focus more on the overall range of the dots than the median. Views for the "longer term" level of rates range from 2.50% to 3.50% for the neutral rate, with 13 of 15 dots sitting at 3% or lower. The distribution of these estimates demonstrates the uncertainty involved in determining the neutral rate and the role of incoming data in determining the policy path.

So far, the Fed's approach to policy has been working. Solid economic growth and a tight labor market with manageable inflation have been a testament to the Fed's ability to balance the two sides of its dual mandate—achieving stable prices and maximum sustainable employment. This pragmatic, balanced approach gives us confidence that the Fed is likely to execute policy effectively as the rate approaches neutral. The Fed has yet to overtighten, and it is aware of the potential dangers, but is also mindful of the later cycle forces that can push up inflation.

CONCLUSION

The later part of the economic cycle, when the two sides of the Fed's dual mandate become more difficult to balance, has always been a challenging period for monetary policymakers. The Fed must find the path that allows the economy to grow without letting forces that may fuel future inflation build to excess. We remain confident that the current flexible approach may lower the likelihood of a policy mistake, although a complex economy often creates unknown challenges. We expect a rate hike from the Fed in December, along with two rate increases in 2019, and we believe a cautious, gradual rate-hike path will continue to support moderate economic growth and manageable inflation. ■

RES 45249 1118 | For Public Use | Tracking #1-798532 (Exp. 11/19)