LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

August 21 2017

JACKSON HOLE PREVIEW

Matthew E. Peterson *Chief Wealth Strategist, LPL Financial*
Shawn Doty *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

The next major event for central bank watchers is the Kansas City Fed's Jackson Hole Symposium this week.

Market reaction to the central bank minutes (Fed and ECB) released last week has been muted thus far.

Both recent central bank meetings contained extended discussions about persistently low inflation.

The Great American Eclipse of 2017 is now over, which may have some believing that the most exciting part of the week has passed. However, for central bank watchers, the fun isn't over, as the Federal Reserve's (Fed) annual Jackson Hole Symposium takes place from August 24–26. This gathering of global central bankers began in 1978 and tends to be closely watched by markets. Though it may not be as exciting as an eclipse, this meeting has been significant historically. Central banks have used the conference to signal upcoming changes to policy, such as the Fed's quantitative easing (QE) programs in 2010 and 2012, and the European Central Bank's (ECB) QE program in 2014.

There will be plenty of speeches and discussions about monetary policy for investors to watch out for throughout the conference. Though Friday, August 25 may be the most closely watched day, as both Fed Chair Janet Yellen and ECB President Mario Draghi are set to speak. Yellen will discuss financial stability and Draghi will cover fostering a dynamic global economy, which is also the overall theme of the conference.

WHAT CAN WE EXPECT OUT OF JACKSON HOLE?

If we had asked market participants what they expect out of Jackson Hole a week ago, some may have indicated that they were watching for signs of normalizing monetary policy. During the June meeting, the Fed outlined how its balance sheet normalization plan will work, but thus far has refused to specify a start date. Markets have also been closely watching the ECB in recent months and listening for any comments regarding any further tapering of its current QE program. Investors will likely stay tuned for updates from the ECB given that Draghi will be speaking at the symposium just two weeks before the ECB's September 7 meeting.

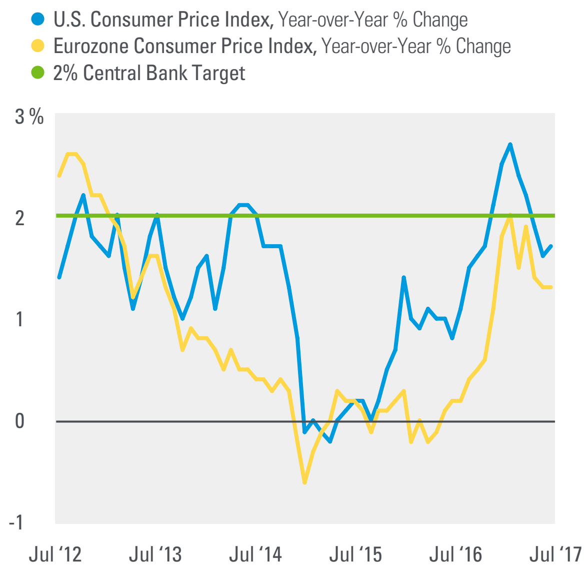
However, over the past week, expectations for a big announcement from either central bank have fallen somewhat, as both the Fed and the ECB just released the minutes from their July meetings. One of the key meeting topics for both central banks was inflation, which is trending below the 2% target both banks use [Figure 1].

JULY MINUTES FOCUS ON INFLATION

Persistently below-target inflation has been an issue in Europe for some time. In addition, the euro has strengthened this year, recently hitting a 2.5-year high. Given this improvement, markets keyed in on the ECB's concerns that if the euro continues to appreciate, it could continue to exert downward pressure on inflation.

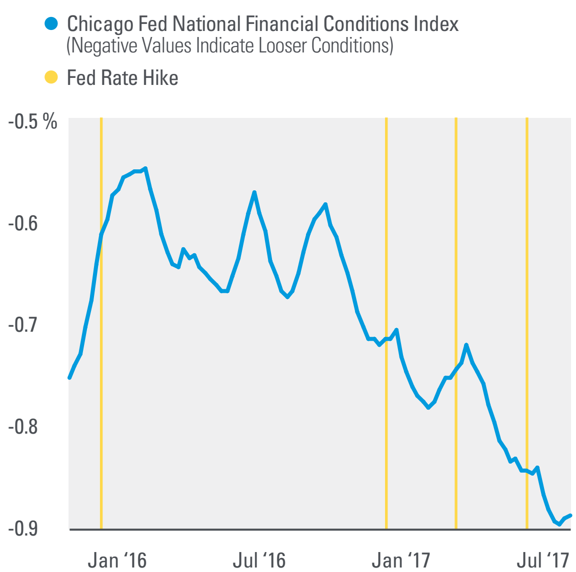
LPL Financial

1 **BOTH THE FED AND ECB MINUTES SHOWED CONCERN ABOUT INFLATION**



Source: LPL Research, U.S. Bureau of Labor Statistics, Eurostat, Bloomberg 08/18/17

2 **FINANCIAL CONDITIONS HAVEN'T TIGHTENED AS THE FED HAS INCREASED RATES**



Source: LPL Research, Chicago Fed National Financial Conditions Index 08/18/17

This may limit the potential for the ECB to taper its QE purchases, given that such a move would likely put more upward pressure on the euro.

At the July Fed meeting there was a lot of discussion about inflation, how it has started to trend below the Fed's 2% target in recent months, and how that may impact the future path of interest rates. More hawkish members of the Fed hold the position that waiting to raise rates could lead to excess future inflation, while the more dovish contingent feels that the Fed can wait until inflation accelerates before aggressively raising interest rates. This discussion isn't new and is likely to continue at future Fed meetings, but the fact that the Fed seemed to be searching for answers on inflation led markets to price in a lower probability of a rate hike at the December meeting, with expectations falling from 43% the day before the minutes were released to 32% currently.

The timeline of when the Fed may begin its balance sheet normalization process matters to investors because the Fed has retained an approximately $4.5 trillion balance sheet since the end of its QE program (October 2014), which has likely kept rates lower than they otherwise would had been. The Fed plans to unwind this balance sheet by allowing a small amount of maturing bonds to roll off each month (initially just $6 billion in Treasuries and $4 billion in mortgage-backed securities [MBS] per month, increasing every three months until it reaches $30 billion in Treasuries and $20 billion in MBS). This is unlikely to have a huge impact on markets initially, but could put some upward pressure on rates over time as it removes one buyer (the Fed) from the Treasury and MBS markets. While a start date for this program has yet to be announced, the consensus opinion continues to point toward a September announcement, though markets will be watching Yellen's comments at Jackson Hole closely for any further hints.

One last thing markets will be watching for is any discussion of financial conditions—a concept that ties in data points from many areas of financial markets, such as volatility, asset prices, bank lending, and many others, to give an indication of the financial situation in a country. Though financial conditions aren't a specific target of Fed policy, they can certainly have an impact. Normally, as the Fed increases interest rates, it would be expected that financial conditions should tighten. However, this hasn't been the case with this rate hike cycle, potentially indicating that the Fed needs to tighten more [Figure 2].

CONCLUSION

The minutes from the July Fed and ECB meetings were taken by markets as broadly dovish, and may point toward less potential for market-moving announcements at the Fed's annual Jackson Hole Symposium. However, markets will continue to watch the proceedings closely for any clues surrounding the future of monetary policy, and will place particular focus on Fed Chair Yellen and ECB President Draghi's speeches on Friday, August 25. ■

RES 6022 0817 | Tracking #1-636124 (Exp. 08/18)