LPL RESEARCH
WEEKLY ECONOMIC COMMENTARY

March 19 2018

# FED PREVIEW

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

## KEY TAKEAWAYS

Jay Powell will preside as chair over his first Fed policy meeting this week.

The Fed's overall assessment of the economy is expected to improve.

Markets anticipate a continued steady but gradual path higher for rates, though they could respond to a meaningful signal of a more aggressive approach.

**Federal Reserve (Fed) Chair Jay Powell will preside over his first Fed policy meeting March 20–21.** Although this is his first meeting as chair, Powell has been a voting member of the policy committee since 2012 and is a seasoned veteran of Fed policy meetings. The Fed is widely expected to raise the target range for the fed funds rate 0.25 percentage points, from 1.25–1.50% to 1.50–1.75%, and anything more (or less) would be a shock for markets. With a rate hike already priced in, markets will be scrutinizing the Fed's policy statement, Powell's press conference following the meeting, and updated economic projections (last released in December 2017) for any hint of changes in the future path of Fed policy.

## THE DOT PLOT THICKENS

The Fed has been signaling, and markets continue to expect, a steady but gradual rise in the Fed's policy rate. In order to help gauge any change in the Fed's expectations, markets monitor interest rate projections via the "dot plots." These estimates, provided by each member of the Fed's Board of Governors and the regional Fed bank presidents, capture the projected level of rates at the end of 2018, 2019, 2020, and in the "longer run," with each view represented by an unlabeled dot. With 12 regional bank presidents and 7 Fed board positions, the maximum number of dots is 19. However, there are four empty board seats following former Chair Janet Yellen's departure, reducing the number of dots in the upcoming projections to 15.

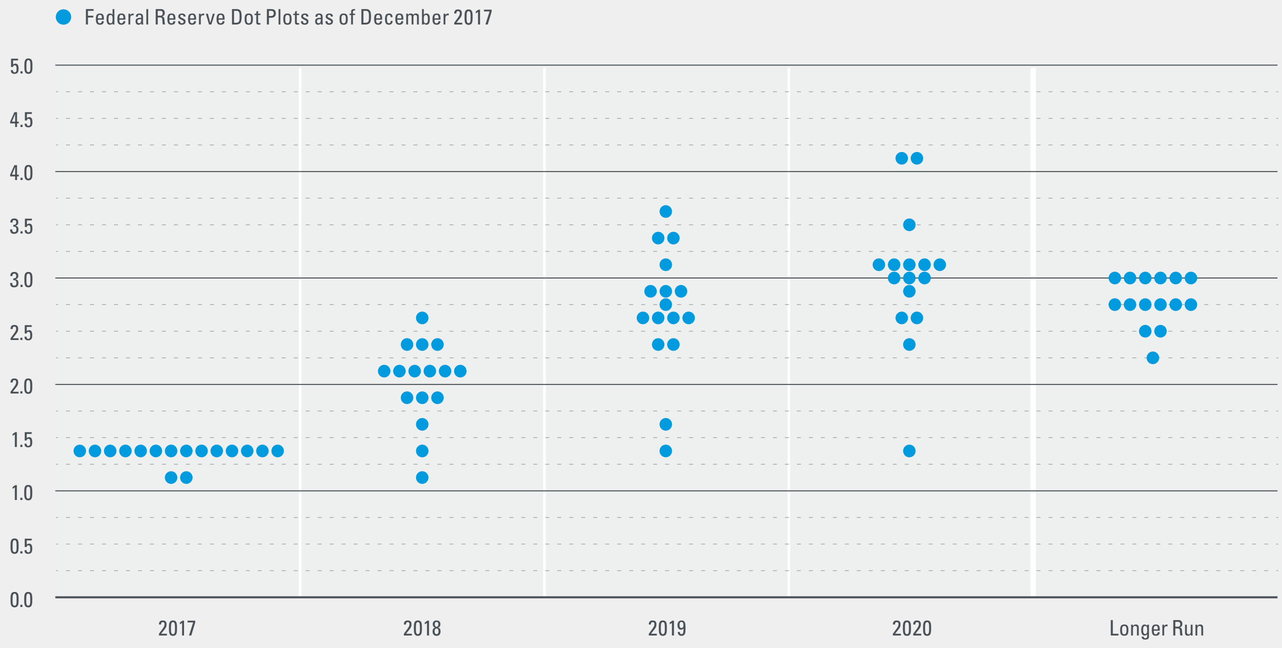
At Wednesday's meeting, with only 15 projections, the eighth dot will be the magical middle, or median, dot. The December 2017 projections had six dots indicating an expectation of fewer than three hikes in 2018, six dots at three rate hikes, and four dots at more than three hikes [Figure 1], putting the median at three hikes. We expect the central tendency of the dots to thicken this time, with dots in the lower range moving toward the middle. With the eighth dot being the median, we would need to see four projections move from an expectation of three rate hikes to four to see the median move. Since the idea of four hikes was only floated by Powell as a possibility in his recent congressional testimony, we believe such a large shift is plausible but unlikely. However, it could become more likely with a significantly more upbeat assessment of the economy.

## FIRST LOOK AT THE IMPACT OF FISCAL STIMULUS

While the Fed will be focused on inflation, inflation expectations are heavily influenced by changes in expected economic growth. The Fed's last set of economic projections was released on December 13, 2017, before the Tax Cuts and Jobs Act passed. Since then we have also seen the Republican-led Congress raise spending limits by $300 billion over the next two years. While fiscal stimulus can provide long-term benefits if it spurs investment, and we believe significant pieces of the tax legislation point in this direction, such a large package of deficit-financed stimulus is unusual at this point in the economic cycle. In particular, the addition of higher spending caps increases the likelihood that recent stimulus may artificially raise growth above potential, pulling future growth forward and increasing upside inflationary risk.

The economic projections accompanying the upcoming meeting will be the first in which Fed members will have the opportunity to fully price in the recent stimulus measures. We did get some sense of Powell's assessment during his congressional testimony in February. Powell's favorable view of the economy led markets to slightly increase the possibility of a fourth rate hike, but the fed funds futures implied odds of a fourth hike have generally remained near a one-in-three chance. In December, the median projection for 2018 gross domestic product (GDP) had already increased to 2.5%, from 2.1% at the September meeting. Expect markets to take a modest further increase in stride. A shift in the median expected growth rate above the symbolic 3.0% level, however, may increase expectations of a more aggressive Fed.

**1 MEDIAN EXPECTATION FOR 2018 HIKES LIKELY TO HOLD STEADY AT 3**



Source: Federal Reserve 03/19/18

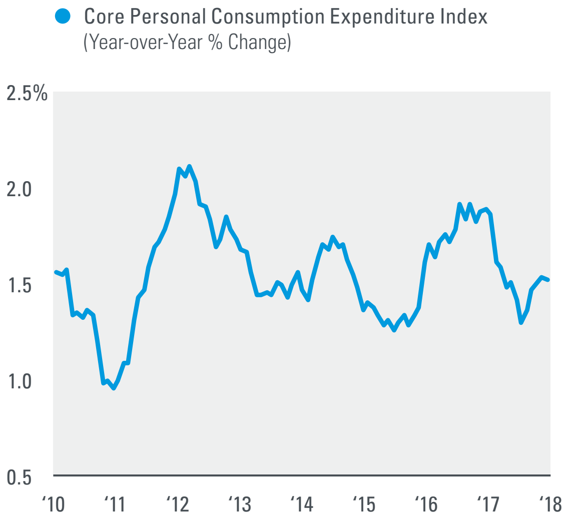
*The 2.0–2.25% range in 2018 represents three expected hikes.

## INFLATION WATCH

The Fed's dual mandate, as the name suggests, has two parts. It seeks to balance the often-competing goals of maximum employment and low, stable inflation. The former usually implies looser monetary policy; the latter, tighter policy. With the economy growing above potential and the unemployment rate well below the short-term natural rate of unemployment (both according to Congressional Budget Office [CBO] estimates), the Fed's attention has increasingly focused on finding the rate hike path that will maintain low and stable inflation with minimum disruption to the economy.

Inflation concerns rose in February with the release of the January employment report. A surprise uptick in wage growth (2.9% year over year versus 2.6% expected) caused markets to wonder if more was on the way. The January Consumer Price Index (CPI) report reinforced these concerns, as both headline and core CPI (excluding food and energy) came in above expectations. These indicators pushed market expectations for the future path of rate hikes higher, with markets starting to price in a chance of a fourth rate hike in 2018.

**2** **CORE PCE HAS RISEN BUT REMAINS WELL BELOW THE FED'S 2% TARGET**



Source: LPL Research, U.S. Bureau of Economic Analysis 03/19/18

Based on the Personal Consumption Expenditures Index. Indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

Fears of escalating inflationary pressures have since faded somewhat. First, February's employment report showed a moderation of wage pressures. Average hourly earnings increased by just 0.1% month over month, bringing year-over-year growth down to 2.6%. January's year-over-year number was also revised lower to 2.8%. February's CPI report, which was released last Tuesday, also met expectations. The headline number did increase slightly to 2.2%, but core stayed the same at 1.8%. Producer Price Index numbers, released on March 14, were also in line with expectations and did little to reignite market fears. It is also important to note that the Fed's preferred gauge of inflation, the core Personal Consumption Expenditures Index (PCE) remained at 1.5% in January and February, well below the Fed's 2% target [Figure 2].

Though inflation headlines are starting to fade, we wouldn't count them out just yet. While wage growth missed expectations in the February report, market expectations for the future path of Fed rate hikes didn't change much, which indicates that markets may continue to believe the story has some legs. Breakeven inflation, a market-based view of inflation expectations measured by the difference between the 10-year Treasury yield and the 10-year Treasury Inflation-Protected Security (TIPS) yield, fell slightly, but has remained in its recent range, and above the Fed's 2% target.

The Fed's most recent Beige Book also showed that businesses were dealing with tight labor market conditions, wage growth had "picked up to a moderate pace," and "most districts saw employers raise wages and expand benefit packages in response to tight labor market conditions." In addition, although wage growth did decelerate in February, it does remain toward the upper end of its post-crisis range.

We believe that the Fed will need to see a sustained pace of higher than expected inflation, and potentially a wage growth number as high as 4% year over year, before they will become markedly more aggressive. For this reason, we continue to believe the Fed will hike rates three times in 2018, with the first coming at the upcoming March 20–21 meeting.

## THE PATH LIKELY REMAINS UNCHANGED

The updated economic expectations and press conference that come with every second Fed meeting will give Fed watchers a lot to digest. We expect an upgrade to growth expectations and some upward shift in the dot plots. However, unless the 2018 median shifts to four hikes or growth expectations break above 3%, the market could read this meeting as reassurance that little has changed. Until we see stronger signs that inflation is picking up, we expect the Fed outlook to hold largely steady. ■

*Special thanks to Shawn Doty for his contributions to this week's publication.*

### IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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### INDEX DESCRIPTIONS

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Producer Price Index (PPI) is an inflationary indicator published by the U.S. Bureau of Labor Statistics to evaluate wholesale price levels in the economy.

### DEFINITIONS

The Beige Book is a commonly used name for the Federal Reserve's (Fed) report called the Summary of Commentary on Current Economic Conditions by Federal Reserve District. It is published just before the Federal Open Market Committee (FOMC) meeting on interest rates and is used to inform the members on changes in the economy since the last meeting.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Treasury Inflation-Protected Securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index (CPI), while providing a real rate of return guaranteed by the U.S. government. However, a few things you need to be aware of are that the CPI might not accurately match the general inflation rate; therefore, the principal balance on TIPS may not keep pace with the actual rate of inflation. The real interest yields on TIPS may rise, especially if there is a sharp spike in interest rates. If so, the rate of return on TIPS could lag behind other types of inflation-protected securities, like floating rate notes and T-bills. TIPS do not pay the inflation-adjusted balance until maturity, and the accrued principal on TIPS could decline, if there is deflation.

Personal consumption expenditures (PCE) is a measure of price changes in consumer goods and services. Personal consumption expenditures consist of the actual and imputed expenditures of households; the measure includes data pertaining to durables, nondurables, and services. It is essentially a measure of goods and services targeted toward individuals and consumed by individuals.

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