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WEEKLY ECONOMIC COMMENTARY

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CENTRAL BANK MANIA CONTINUES

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KEY TAKEAWAYS

The past week has been a busy one for global central banks, with the BOJ and ECB meeting last week, and the Fed's two-day meeting ending July 26.

The July FOMC meeting is unlikely to see any major changes, and the Fed will not issue new economic projections or hold a press conference.

Markets will be watching the Fed's statement closely for any hints of a start date for balance sheet normalization and the future path of rate hikes.

The conclusion of the Federal Reserve's (Fed) meeting on July 26 will end a busy seven days for central bank watchers that also saw meetings for two other major central banks — the Bank of Japan (BOJ) and the European Central Bank (ECB). The Fed's policy meeting will end with a prepared statement, but will not feature any new economic projections or a press conference. The excitement seen at the Fed's last meeting in mid-June, which included a rate hike and additional details regarding balance sheet normalization (see blog from June 14), is unlikely to be repeated, with markets pricing in only a 3% chance of a rate hike at this meeting. However, markets will closely read the Fed's statement for any hint of the start date for balance sheet normalization and the future path of rate hikes.

BOJ AND ECB TAKEAWAYS

The BOJ and ECB both met last week, though neither offered much in the way of surprises. The BOJ left its policies unchanged, keeping its policy rate at -0.1% and continuing to target the 10-year Japanese Government Bond around 0%. The BOJ did raise its assessment of the Japanese economy slightly, but lowered its inflation forecasts. It now expects inflation to reach its 2% target in its 2019 fiscal year (FY), which runs from April 1, 2019 to March 31, 2020. It previously had expected the 2% target to be reached in FY 2018.

Prior to the ECB meeting, Mario Draghi had given a speech in Sintra, Portugal on June 26, 2017 that markets interpreted as leaning hawkish, leading to a move higher in both foreign and domestic rates. While the speech wasn't that different from Draghi's previous statements (see blog from June 30), markets keyed in on a few points about the recovery in the European economy and the potential for an eventual end to the ECB's negative interest rate and quantitative easing (QE) polices. Following these comments, markets were watching last week's ECB meeting closely for any changes to the bank's outlook and for any hint of further tapering of QE.

The ECB's policy statement was basically status quo, though it did maintain a dovish tilt regarding inflation, indicating that "measures of underlying inflation remain overall at subdued levels," and that, "a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up and support headline inflation developments in the medium term."

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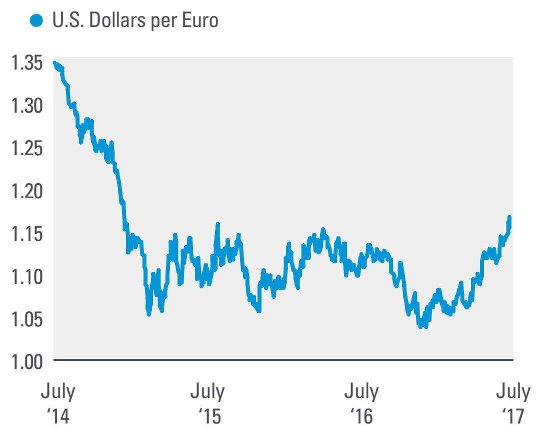
During the Q&A session, Draghi indicated that the council was "unanimous in setting no precise date for when to discuss changes in the future" pace of its QE purchases. Markets, however, continue to expect a potential announcement regarding a further tapering of QE in either September or October. Interestingly, even though the ECB's statement was basically status quo, markets don't appear to be buying the ECB's message, as the euro has headed higher to hit its strongest level versus the dollar since January 2015 [Figure 1].

1 THE EURO REACHED A TWO-YEAR HIGH VERSUS THE DOLLAR FOLLOWING THE ECB'S JULY MEETING



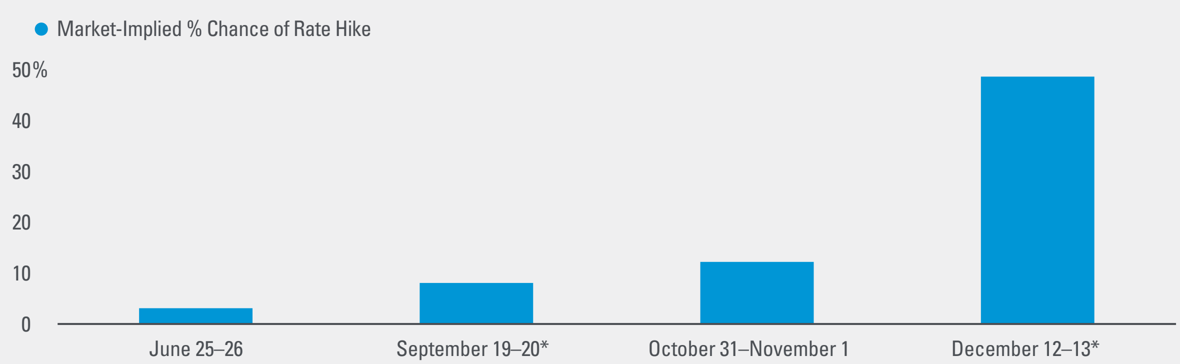
Source: LPL Research, FactSet 07/21/17

FED PREVIEW

The July meeting of the Federal Open Market Committee (FOMC), the policy arm of the Fed, will take place this Tuesday and Wednesday, July 25–26. After raising rates in June for the fourth time this cycle, market expectations for a rate hike are very low, near 3% currently. Though the projections from the June Fed meeting showed a median expectation of one additional rate hike by the end of 2017, markets are less certain, pricing in slightly less than a 50% chance of a rate hike by the Fed's December meeting [Figure 2].

The Fed released details about its balance sheet normalization plan at its June meeting, but one major question that remains unanswered is the start date. Markets currently expect that the Fed will wait until at least its September meeting to begin implementation of the plan, but official statements from the Fed have been vaguer, hinting at start dates ranging from September to December 2017. Though markets are eagerly awaiting a start date, the immediate impact of normalization is likely to be limited given that it will start with allowing just $10 billion ($6 billion of Treasuries and $4 billion of mortgage-backed securities [MBS]) of maturing bonds to roll off the $4.5 trillion balance sheet each month.

2 MARKET EXPECTATIONS FOR ADDITIONAL RATE HIKES IN 2017 REMAIN BENIGN



Source: LPL Research, CME Group 07/24/17

*Meeting accompanied by updated economic projections and a press conference

Market implied rate hike expectations are calculated based on the pricing of various fed funds futures contracts. Rate Hikes may not develop as predicted.

The Fed's current plan is to increase this number by $10 billion every three months, until it reaches a maximum of $50 billion per month ($30 billion of Treasuries and $20 billion of MBS). This pace will then continue until the balance sheet reaches a size the Fed is comfortable with. The Fed has said that this number will likely be larger than the pre-crisis level of roughly $900 billion, but an exact figure has not been provided.

Overall, it appears that the July meeting may elicit little response from markets. The policy statement will not be accompanied by updated economic projections or rate expectations, and market participants will have to parse the brief policy statement itself, released at 2 p.m. ET on July 26, to gain any further insight on the Fed's intentions. Markets will continue to watch the statement closely for any signs of change, especially to the Fed's view of inflation, which was downgraded at the June meeting.

Following the July meeting, the next major Fed meeting, which will include economic projections and a press conference, will take place September 19–20. However, markets will have plenty of Fed speak to digest before then, with the minutes of the July meeting expected on August 16, and the Fed's annual Jackson Hole Symposium taking place August 24–26.

CONCLUSION

The fact that three major central banks met in the seven days between July 19 and July 26 makes for a lot of headlines and speculation in a short period of time. However, after relatively benign statements from the BOJ and ECB last week, and low expectations for any changes at the Fed's meeting later this week, the actual impact to markets may end up falling flat. ■

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