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WEEKLY ECONOMIC COMMENTARY

KEY TAKEAWAYS

Recent Fed communication reinforced its view that gradual hikes were the appropriate response to a strong economy, near-target inflation, and balanced risks.

Fed Chair Jerome Powell's emphasis on a pragmatic approach to assessing a neutral policy rate may help reduce the chance of a policy mistake.

Trade tensions received increased attention in the Fed minutes as a potential risk, although the economic impact to date has been minimal.

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POWELL'S POLICY PRAGMATISM

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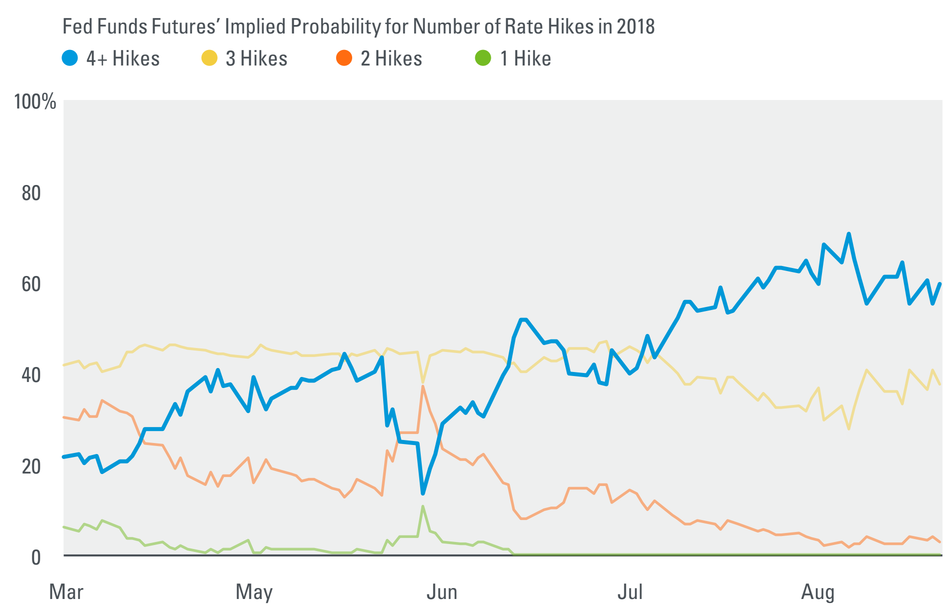
Federal Reserve (Fed) Chair Jerome Powell's speech Friday at the Economic Policy Symposium in Jackson Hole, Wyoming, served as a fitting complement to the minutes from the Fed's most recent policy meeting. Both Powell's comments and the minutes reinforced the Fed's strong case for hiking rates for the third time this year when it meets in September, an outcome the markets are largely expecting [Figure 1].

The path of rate hikes beyond September is less certain, given strong growth but still-contained inflation and largely balanced upside and downside risks.

Powell's pragmatic emphasis in his Jackson Hole speech leaned slightly dovish. We should see 1–2 more hikes in 2018, but Powell's continued commitment to flexibility in assessing the economy increases our confidence that the Fed may be able to avoid the kind of policy mistake that contributed to some past recessions.

1 AT LEAST THREE 2018 RATE HIKES APPEAR TO BE A LOCK; FOURTH HIKE POSSIBLE BUT UNCERTAIN



Source: LPL Research, Bloomberg 08/22/18

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

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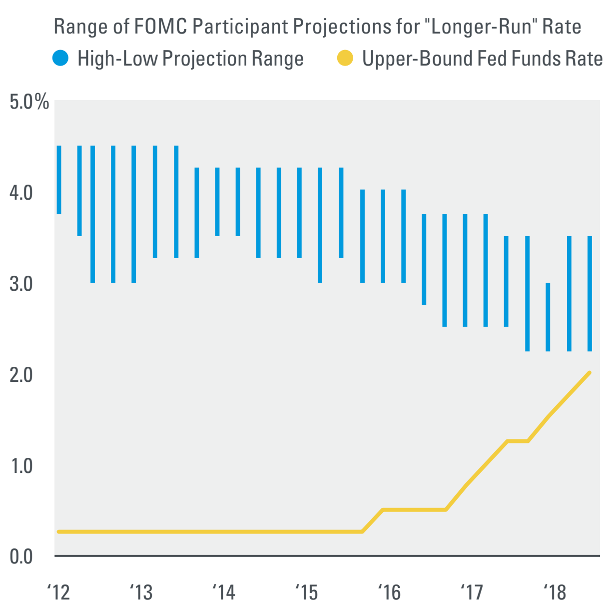
U.S. ECONOMIC GROWTH REMAINS STRONG

On balance, the Fed's view of U.S. economic growth has improved from already solid levels over the past few months. In the minutes of the Fed's last meeting, which ended August 1, policymakers characterized gross domestic product (GDP) and non-farm payrolls growth over the past few months as strong, However, they predicted inflation would stay around the Fed's 2% target over the medium term. Powell reiterated these trends at Jackson Hole, saying that while economic and job growth is strong, the Fed still does not perceive an elevated risk of the economy overheating.

THE AMBIGUOUS "NEUTRAL RATE"

Fed policymakers have stated recently that the federal funds rate is continually moving closer to the "neutral rate", the point where monetary policy is neither stimulating nor restraining the economy.

2 NEUTRAL POLICY RATE IS NOT A "FIXED STAR"



Source: LPL Research, Bloomberg 08/24/18

FOMC: Federal Open Market Committee

Projections may not develop as predicted.

However, the Fed's range of longer-run neutral rate estimates has shifted lower over time and widened as the U.S. economy has moved further into the economic expansion [Figure 2], hinting at the challenge of reconciling robust economic growth with inconsistent inflationary pressures.

Powell's pragmatism was put on display at Jackson Hole in his discussion of the "neutral rate," and clues in the minutes of the last meeting indicate his perspective may be having an impact on framing policy discussion. Minutes from the Fed's June policy meeting signaled policymakers were treating the neutral rate as more of a fixed "star." Fed members also expressed their intention to "continue gradually raising the target range for the federal funds rate to a setting that was at or somewhat above their estimates of its longer-run level by 2019 or 2020." However, in the last meeting, policymakers did not mention any estimates of a target date for hitting the neutral rate, placing greater emphasis on an assessment of upside and downside risks to inflation and the economy. In Powell's Jackson Hole speech, he focused heavily on how the Fed is responding to structural changes ("shifting stars") in the U.S. economy, specifically the neutral real rate of interest (the neutral rate adjusting for long-term inflation) and the natural rate of unemployment. We interpret Powell's "shifting stars" analogy as a nod to the Fed's need to look beyond theoretical constructs to the complexities of a living, breathing economy. Powell emphasized the Fed continues to evaluate the risks between moving too quickly and too slowly, and will look for signs of excesses beyond inflation, as inflation alone may not provide an adequate signal for an overheated economy.

Powell did indicate satisfaction with the current Fed policy of gradually raising rates, noting that the absence of any notable signs of overheating despite a strong economy can, at least in part, be attributed to the slow removal of accommodative monetary policy.

INCREASED ATTENTION ON TRADE

There was considerably more discussion about trade relations and tariffs at the Fed's last meeting compared with its June meeting. Trade took up significantly more real estate in the minutes, and there was an important statement of consensus around prospective and already imposed tariffs. Policymakers then noted that a prolonged trade dispute could have adverse effects on business sentiment, investment spending, and employment. Policymakers' comments about trade in the last meeting indicate they expect significant economic implications if tariffs persist or worsen.

CONCLUSION

Powell's pragmatic approach to evaluating risks, including a greater emphasis on sensitivity to a wide variety of market and economic signals and an acknowledgement of their uncertainty, demonstrates the value of his business background. This approach may not give investors the clarity they want from a Fed chair, but it's appropriate given the complicated nature of the domestic and global economy right now. Powell's approach is cautious and measured, which we believe may reduce the Fed's chances of making a policy mistake. ■

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