LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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FED MEETING PREVIEW

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KEY TAKEAWAYS

An interest rate hike later this week appears to be a foregone conclusion, so investors will likely be focusing on policy implications for 2019.

Markets will be scrutinizing the Fed for clues on the "neutral rate," or the rate at which monetary policy is neither accommodative nor restrictive.

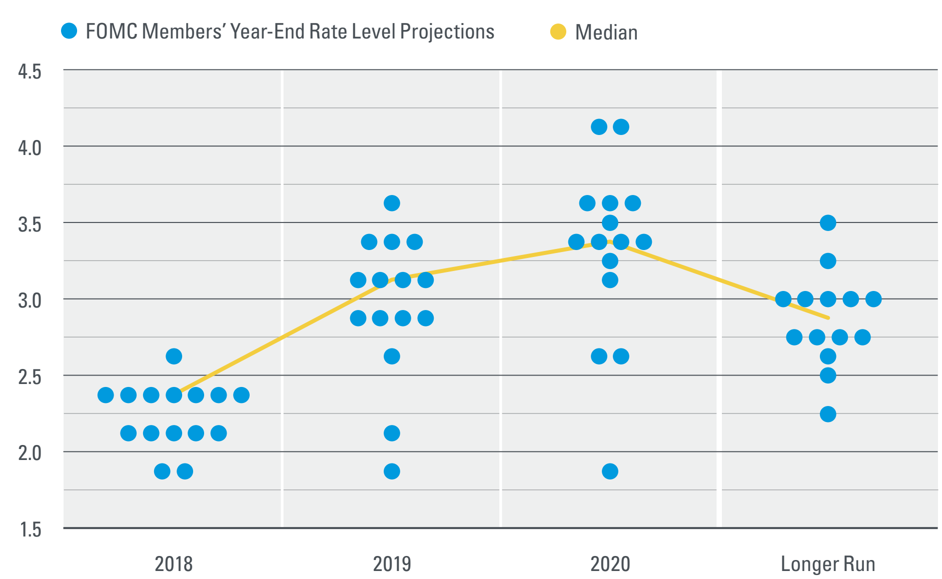
Given solid economic growth and strong labor markets, markets will be looking for any change in the Fed's views of inflation.

The Federal Reserve's monetary policy meeting will be a focal point for markets this week. The two-day meeting will culminate in a policy decision, new economic projections, and a press conference from Fed Chair Jerome Powell on Wednesday. An interest rate hike is almost a foregone conclusion: Fed funds futures are pricing in a 98% chance of an interest rate increase. Markets will be more focused on implications for policy direction through the end of 2019, as the Fed tries to move toward a neutral policy stance without overtightening.

LOOKING AHEAD

Investors' attention has largely shifted from the current fed funds rate to the Fed's projections for future policy and economic growth [Figure 1]. Currently, the markets are parsing the Fed's words for clues on the "neutral rate," or the point where monetary policy is neither stimulative nor restrictive. The neutral rate is a practical idea rather than a known macroeconomic variable, and it takes a pragmatic policy approach to move toward the neutral rate while avoiding the risks of overtightening or leaving policy too loose.

1 AS OF JUNE, FED'S DOT PLOT PROJECTS FIVE RATE HIKES BEFORE END OF 2019



Source: LPL Research, Bloomberg 09/20/18

Economic forecasts may not develop as predicted.

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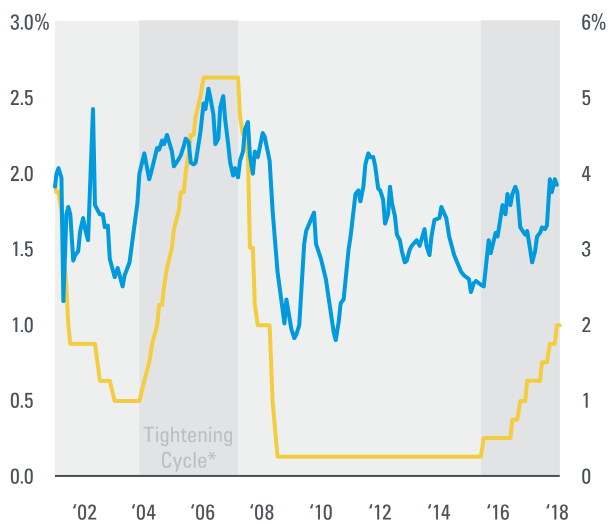
We get some sense of the Fed's current views on rates via the projections provided at every other meeting. These estimates, provided by each member of the Fed's Board of Governors and the regional Fed bank presidents, capture the projected level of rates at the end of each year and in the "longer term," with each view represented by an unlabeled dot, which gives the "dot plot" its name.

The last set of projections, released following the June meeting, implied that policymakers expected a slower pace of rate hikes moving into next year. The median dot plot forecasted four rate hikes in 2018 (to a fed funds rate range of 2.25–2.5%), and three hikes in 2019. The "neutral rate" estimates correspond to the longer-term expectations, with a median of between 2.75% and 3.0%. But the longer-term estimates cover a wide range, from as low as 2.25% to as high as 3.5%. It's also important to keep in mind that the neutral rate is not necessarily a single point, but likely covers a range in which policy could still be considered largely netural.

2 CORE PCE SHOWS INFLATION IS MUTED COMPARED WITH LAST TIGHTENING CYCLE

- Year-over-Year Core Personal Consumption Expenditures (PCE) Growth *(Left Scale)*
- Upper Bound Fed Funds Rate *(Right Scale)*



Source: LPL Research, Bloomberg 09/20/18

A tightening cycle is a period in which the federal funds rate increases.

One signal that we're approaching that range will be the Fed's removal of the description of current policy as "accommodative" in its policy statement. While this change may create short-term uncertainty for markets as they absorb the implications, in the end, earlier removal would likely be more market-positive than later removal, since it would signal that we were near the neutral rate. We think the language is unlikely to change at this meeting, but the discussion is actively taking place and a change at the current meeting is possible.

MIXED SIGNALS

The Fed will also provide an updated forecast for U.S. economic growth. This particular update could shed light on the Fed's evaluation of the economy's generally positive signals along with some potential crosswinds, which have intensified since policymakers' June forecast of 2.8% gross domestic product (GDP) growth this year.

Overall, U.S. economic data has improved modestly. The economy grew at 4.2% in the second quarter, the strongest quarter of growth since 2014. The job market continues to tighten amid solid payroll growth, while the unemployment rate has dipped to an 18-year low. Spending has also picked up significantly as U.S. businesses and consumers realize a $350 billion windfall from fiscal stimulus. Personal incomes have risen at the fastest pace in nearly three years, while wage growth is at its strongest level of the cycle. We think modestly accelerating wage growth will continue to boost personal incomes and fuel consumer spending, which accounts for about 70% of GDP.

With the economy doing well, the potential for a pickup in inflation will be the Fed's main focus, and markets will be looking for any sign of increased concern. While pricing and wage pressures have accelerated recently, they are still at historically subdued levels. Core Personal Consumption Expenditures (PCE), excluding food and energy prices, just reached the Fed's target of 2% last month for the first time since 2012 [Figure 2].

Even so, the Fed has publicly emphasized the "symmetric" nature of this target, a signal that policymakers may be willing to let inflation run a little hot if they believe the effect may be temporary. Inflation risks remain balanced, with threats from wage pressure and trade restrictions offset by a strong dollar, contained inflation expectations, and the prospect that growth, while remaining steady, will moderate.

Trade tensions continue to create some economic uncertainty and added potential inflationary pressure, although recent readings indicate that any pressure to date has been manageable. Last week, the U.S. announced a round of tariffs on $200 billion in Chinese goods and threatened steepening the rate if a trade agreement isn't reached by year-end. China retaliated with additional tariffs on $60 billion in U.S. goods. While the United States' promised escalation could force a negotiation between the two countries, an agreement before the midterm elections is unlikely, and a prolonged standstill could weigh on economic growth.

The Fed has taken note of the potential negative implications of continued trade tensions. In the Fed's last meeting, there was considerably more discussion about trade relations and tariffs, and there was an important statement of consensus around the uncertainty from prospective (and already imposed) trade restrictions. Some global markets are also in recovery mode after a recent bout of emerging-market turmoil, and the Fed must consider how to maintain global stability when determining future monetary policy.

CONCLUSION

This week's Fed policy meeting will provide a lot of material for markets to digest, including new projections and a press conference by Fed Chair Powell. With a rate hike all but priced in, markets will be focused on the policy path in 2019 and any sign of changes in inflation expectations. We expect an emphasis on flexible policy that remains data dependent, with some implied assurance that the Fed is aware of potential risks from overtightening. Any change in the Fed's view of inflation could roil markets, but we believe recent readings will allow the Fed to continue to view inflationary risks as balanced, leaving room for it to continue to hike rates gradually with a potential slowdown in the pace as we approach the neutral rate. ■