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FED MINUTES WRAP-UP

INFLATION TARGET SYMMETRY

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

KEY TAKEAWAYS

The Fed minutes' emphasis on a symmetric inflation target reassured markets that the pace of rate hikes would remain gradual.

At the same time, the Fed's economic assessment stayed generally upbeat.

The minutes all but committed the Fed to a rate hike in June.

The Federal Reserve (Fed) reassured markets that its rate hike pace would remain gradual with the release of its May 1–2 policy meeting minutes last Wednesday. While the minutes revealed a generally upbeat assessment of the economy consistent with Fed views since the start of the year, markets read the overall tone of the minutes as modestly dovish, helped by some context on the Fed's additional emphasis that its 2% inflation target is "symmetrical." The language has been widely used in the minutes and statement for some time, but garnered closer scrutiny after the policy statement added the phrase again in a key passage. By highlighting that its inflation target was symmetrical, the Fed reminded markets that it does not think of its target as a line in the sand, but as a goal that will have some wiggle room.

In response to the minutes, shorter maturity Treasury yields and market-implied rate hike expectations fell, while equities moved higher. The takeaway for markets is that for now, the economy remains in a sweet spot. It's healthy enough that the Fed is slowly normalizing policy, as it should, but at a pace that will allow economic momentum to continue. We agree with this assessment, and while the potential for policy acceleration remains a risk, the current focus should remain on above-trend economic growth and what it means for consumers, businesses, and markets.

THE SETUP: WHAT MARKETS WERE WATCHING

While there is little to indicate that the economy is overheating and inflation shows few signs of running hot, there are signs that the economy is in the late stage of the economic cycle, when the excesses that cause recessions start to build. Growth is expected to run above its long-term potential, labor markets are getting tight and it's getting harder for businesses to find people with the right skills, and the federal government is accelerating deficit spending at a rate unusual outside of recessions and wartime. Despite its name, the "late" stage of the economic cycle is actually often a period of strong growth accompanied by rising markets and typically lasts several years.

Nevertheless, as excesses build, market participants will carefully eye the Fed for signs that they are putting on the brakes. We are not near that point right now. The Fed still characterizes its policy as accommodative; that is, adding support to the economy instead of maintaining just a neutral stance. But given how long that period of accommodative policy has lasted and the role the Fed

has played in sustaining the expansion, even a shift from accommodative to neutral brings with it a sense of uncertainty.

The Fed's assessment of the economy has generally improved over the last year, but its gradual pace of policy normalization has allowed good economic news to continue to be good news for markets as well. Inflation is the main gauge to watch to judge whether this can continue. In fact, the catalyst for the market volatility that began in late January was concern that wages were beginning to push higher. Inflation has picked up and the Personal Consumption Expenditure Index (PCE) ex-food and energy, the core version of the Fed's preferred measure of inflation, has accelerated toward the Fed's 2% target but has not yet breached that level, and in fact has not been over target since a brief stretch in early 2012 [Figure 1].

As the economy continues to improve, Fed watchers have been speculating whether the expected three rate hikes in 2018 are likely to

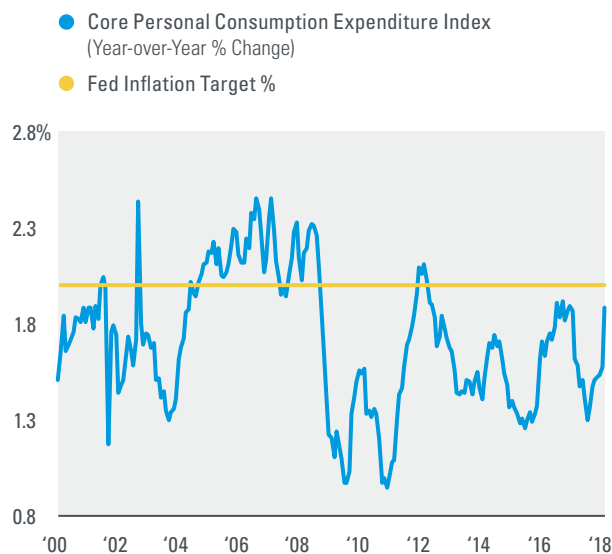
become four. The difference between three and four rate hikes in a year is actually not that meaningful in itself, but it does signal the economy is running hotter than the Fed expected at the end of 2017 and would imply that the path for rates would be accelerated, assuming continued confirmation from the data.

WHAT THE MINUTES TOLD US

The overall assessment of the U.S. economy in the minutes remained generally positive, with forecasts pointing to above-trend growth in 2018. Participants viewed current policy to be well matched with economic expectations. There was little to indicate support for more aggressive policy, but a few participants did note that "inflation was likely to move slightly above the Committee's 2 percent objective for a time." This was immediately qualified by a comment noting that "a temporary period of inflation modestly above 2% would be consistent with the Committee's symmetric inflation objective," standard language but telling in context due to its connection to concerns about inflation running above target and the additional reference to a symmetrical target in the May 2 policy statement. Fed watchers generally took the new term in the policy statement to indicate that the Fed was comfortable with inflation running a little hot, and the minutes confirmed that view.

One way to view the market response to the Fed's statement is to look at changes in market-implied expectations of four or more rate hikes in 2018 [Figure 2]. Expectations hardly moved immediately following the policy meeting, and in fact they proceeded to slowly rise as new economic data largely met expectations. Between the end of the policy meeting and the release of the minutes, the implied probability of four or more rate hikes, in fact, rose from 32% to 43%, not a large move but directionally meaningful. Following the release of the minutes they fell to 28%, an unusually sharp move, and as of Friday, May 25, had settled at 25%. If the Fed was trying to send a message, it

1 FED'S PREFERRED INFLATION MEASURE STILL BELOW TARGET



Sources: LPL Research, U.S. Bureau of Economic Analysis 05/25/18

The Personal Consumption Expenditures Index measures price changes in consumer goods and services. Core excludes the highly volatile food and energy prices.

Past performance is no guarantee of future results.

was the minutes, rather than the policy statement, that achieved its goal.

WHAT TO WATCH FOR NEXT

A rate hike at the Fed's next policy meeting, June 12–13, appears to be a near certainty. The Fed all but committed to it in the minutes, and fed fund futures implied odds are in agreement, pricing in a near 100% chance of a hike. Of greater interest, the next meeting will also include new economic projections, including the expected path of rate hikes via the "dot plots," as well as a post-meeting press conference with Fed Chair Jerome Powell. Despite the change in fed fund futures-implied expectations of a fourth rate hike in 2018, the median forecast in the last set of economic projections was only one "dot" away from moving to four hikes. That is, only one participant's projection or "dot" needs to shift from expectations of three or fewer rate hikes in 2018 to

four or more for the median dot to shift from three to four. This would be a small shift, granted, but still symbolic and potentially enough for a modest short-term market reaction.

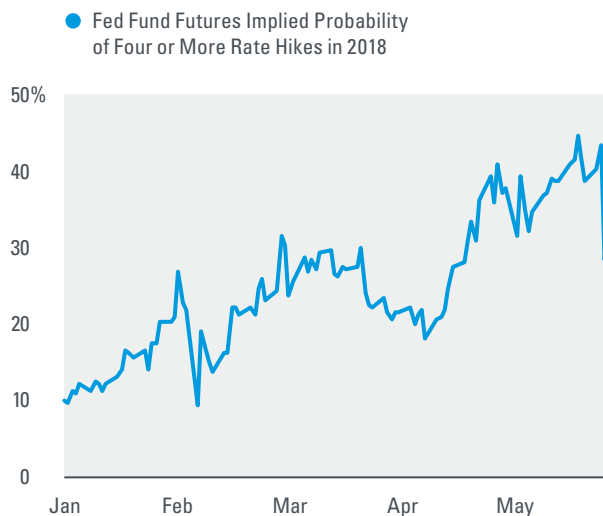
The minutes also mentioned discussion of the potential future removal of policy statement language about the fed funds rate running below the longer run rate "for some time" and that "the stance of monetary policy remains accommodative." While unlikely to happen at the next meeting, if the economy remains on track we'll probably see this language change by the end of the year. While such a change would be largely symbolic, it would mark the completion of the process, already well in hand, of monetary policy moving to the sidelines and market forces, nudged by fiscal policy, determining the direction of the economy.

CONCLUSION

There was little surprising in the minutes of the Fed's May 1–2 policy meeting, but market participants and Fed watchers were reassured that their interpretation of the policy statement released in early May was correct. The Fed continues to navigate the challenging process of policy normalization that it started back in December 2013, when it announced it would start tapering bond purchases, and has been able to gradually scale back accommodative policy since with little economic disruption.

While policy normalization can often come with increased market volatility, this kind of volatility is the natural companion to a healthy economy driven by a more traditional business cycle. The possibility of a policy mistake remains an economic risk, but we continue to believe that the economic growth that has led the Fed to raise rates is a more potent force than the higher rates themselves, and that the economy can continue to tolerate policy normalization at a gradual pace. ■

2 FED MINUTES LOWERED ODDS OF FOUR HIKES



Sources: LPL Research, Bloomberg 05/25/18

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

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