LPL RESEARCH

BOND MARKET PERSPECTIVES

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CENTRAL BANK STEEPENER AHEAD?

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KEY TAKEAWAYS

The Fed, ECB, and BOE are all scheduled to meet this week.

Markets have already priced in a Fed rate hike in December, but the central bank's economic projections and forecast of the future path of rate hikes will be closely watched.

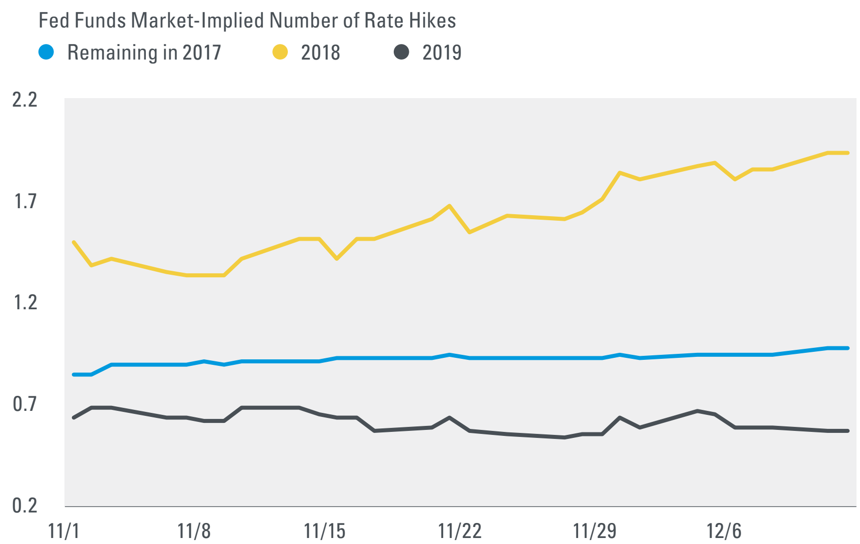
Recent strong economic data out of the Eurozone has markets watching for a possible upgrade to growth projections from the ECB.

The coming week will be a busy one for central banks, with the Federal Reserve (Fed), European Central Bank (ECB), and Bank of England (BOE) all scheduled to hold policy meetings. The Bank of Japan will also meet the following week, with its statement coming on December 21. Outside of a potential Fed hike, we don't expect much in the way of policy updates from any of these central banks. However, the general theme of central banks moving in the direction of moderating accommodation, or in the case of the United States normalizing policy, is likely to remain intact, as outlined in our *Outlook 2018*.

FEDERAL RESERVE: RATE HIKE ON DECK

We don't expect any changes to the Fed's balance sheet normalization plan, but we do continue to expect that the Fed will announce a 0.25% rate hike at the conclusion of its December 12–13 meeting, bringing the fed funds rate to a still historically low range of 1.25% to 1.50%. Fed funds futures markets have

1 MARKET EXPECTATIONS FOR 2018 RATE HIKES HAVE INCREASED IN RECENT WEEKS



Source: LPL Research, Bloomberg 12/11/17

Market-implied rate hike expectations are calculated based on the pricing of various fed funds futures contracts. Fed Funds Futures are a product offered by the Chicago Board of Trade which allow investors to speculate on what the Federal Reserve will do with interest rates. Rate hike expectations may not develop as predicted.

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already priced in such a move, making it unlikely to have much of a market impact. However, the Fed's statement, economic projections, and post-meeting press conference are likely to be closely scrutinized by markets, in an attempt to determine what it all means for the future path of rate hikes. The Fed's latest projection showed that its median expectation is for one rate hike in December, three in 2018, and at least two in 2019. Markets are, as usual, pricing in a slower path than the Fed. However, expectations for 2018 (now at about two rate hikes) have increased in recent weeks, at the expense of 2019 (where not even one rate hike is fully priced in).

The biggest headache for the Fed (and other developed central banks) in 2017 has been below-target inflation. We don't expect any breakthroughs in this area during this meeting, but market participants will be closely watching the Fed's economic projections and statement to see if there are any changes to labor market conditions or inflation expectations.

In the near future, markets will also be monitoring the impact of tax reform on the Fed's economic projections, and any changes to communication style under incoming Fed Chair Jerome Powell, though, markets may have to wait on both of these items. Given that a final tax bill won't be in place before the Fed's December meeting, the earliest markets are likely to receive official guidance from the Federal Open Market Committee (FOMC) on this topic may be in the January meeting statement or the minutes of the January 30–31, 2018 meeting, though individual Fed speakers may make their personal opinions known before then. However, the January meeting will not have updated economic projections, which means investors may ultimately have to wait for the March 20–21, 2018 meeting for more in-depth information. March's meeting will also be important because it will be the first under Powell's leadership. Though most expect monetary policy will continue on its current trajectory, investors will be watching closely for any sign of changes to Fed communication policies.

EUROPEAN CENTRAL BANK: UPDATED ECONOMIC PROJECTIONS

The ECB will release its latest statement on December 14, 2017. The central bank is unlikely to embark on any new policy initiatives, as it announced a tapering of bond purchases from 60 billion euros per month to 30 billion euros per month (effective in January) at its last meeting in October.

Similar to the Fed though, the ECB will also release updated economic projections for the Eurozone. The ECB's latest projections from their September 2017 meeting showed Eurozone economic growth peaking at 2.2% in 2017, before falling to 1.8% in 2018 and 1.7% in 2019. However, a recent string of positive economic data has markets expecting that the ECB could increase its growth and inflation expectations for 2018 or beyond.

This will also be the first meeting where the ECB will release projections for 2020. Markets will be watching both the near- and long-term projections very closely to see if the central bank expects growth to slow further in the coming years. An upgrade in growth expectations could cause long-term yields to move higher (as these yields are driven mostly by expected growth and inflation dynamics), which could lead to a steeper yield curve in the Eurozone. Given that low rates overseas have helped keep long-term Treasury yields lower than they otherwise would be, this could also lead to a steepening of the yield curve in the United States, making this meeting worth watching for U.S. investors.

BANK OF ENGLAND: BREXIT UPDATE

The BOE raised interest rates for the first time since late 2007 at its November 2 meeting, but also cut forward guidance for rate hikes due to the potential for Brexit-related headwinds. There is little expectation of further policy moves from the central bank at the December 14 meeting, even though headline inflation in the U.K. recently surprised to the upside at 3.1% (versus 3.0% expected). Markets may be able to glean some additional insights on the bank's thinking regarding recent Brexit developments, though even this aspect of the meeting may be overshadowed given that the European Council will be meeting the same day. This is the body that will decide if the European Union (EU) believes Brexit negotiations have made sufficient progress to be able to move forward to trade talks, a very important step to minimize uncertainty for businesses before the U.K. exits the EU in March 2019.

CONCLUSION

The Fed, ECB, and BOE will all hold regularly scheduled monetary policy meetings this week, though markets already have a pretty good idea of what each bank will say. We do expect the Fed to raise rates by 0.25%, but we don't expect any new policy initiatives from the ECB or BOE. Economic projections from the Fed and ECB, along with ongoing Brexit negotiations between the U.K. and EU, are likely to be bigger drivers for markets this week, though the statements of each central bank will also be closely scrutinized. We expect that major global central banks will continue down the path of reducing stimulus and moving toward policy normalization in the coming year, as outlined in our *Outlook 2018.* ■

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