LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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FORECASTING FOLLIES:

FED HITS ITS MARK IN 2017

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KEY TAKEAWAYS

In 2017, the Fed hit its mark for the expected number of rate hikes after missing by a wide margin in the prior two years.

Market-implied expectations have been more accurate, but also overly optimistic.

Forecasters in general have expected rates to move toward long-term norms faster than they actually have.

With the end of the year fast approaching, 'tis the season for reflection on forecasts past and the sharing of forecasts future. We do not have an award for "Forecast of the Year," but if we did, in 2017 it would go to the Federal Reserve (Fed). While the Fed's "dot plots" are not a forecast strictly speaking, it's fair to take the median dot as a rough consensus view. With its rate hike last week, the Fed hit its mark of three hikes in 2017, matching the view set out in its final set of dot plots in 2016. With the economy surprising to the upside, the Fed was able to follow through on its expected rate hike path in 2017, and begin to reduce its balance sheet.

THIRD TIME'S THE CHARM

Throughout this economic cycle, markets, forecasters, and even the Fed have consistently overestimated the path of interest rates, expecting them to go higher. The Fed itself had a number of false starts, as its quantitative easing (QE) program ended twice, only to be restarted. The wind-down of the third round of QE took place roughly on schedule, with the Fed voting to end the program in October 2014. We did see follow-through with the first hike of the cycle in December 2015; however, the median forecasts at year-end 2014 (for 2015) and at year-end 2015 (for 2016) projected four hikes each year. As it turned out, we only had one increase in each of those years [Figure 1].

1 THE YEAR-AHEAD MEDIAN "DOT PLOT" FORECAST HAS BEEN TOO OPTIMISTIC...UNTIL 2017

Date of Forecast	Forecast Target Date	FOMC Median	Market Implied	Actual # Hikes
January 2012	December 2012	0	0	0
December 2012	December 2013	0	0	0
December 2013	December 2014	0	0	0
December 2014	December 2015	4	2	1
December 2015	December 2016	4	3	1
December 2016	December 2017	3	3	3
December 2017	**December 2018**	**3**	**2**	**?**

Source: LPL Research, Federal Reserve, Bloomberg 12/15/17

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. There is no guarantee that rate hikes will develop as forecasted.

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These misses make 2017 noteworthy. The Fed raised rates three times in 2017—matching the forecast made in December 2016 and aligning with the market's expectations as well. Looking ahead, the median dot plot forecast for 2018, at the December 2017 Fed meeting, was for another three rate hikes in 2018. Is the Fed now on a roll? The real question here is whether the economy is on a roll. As discussed in our *Outlook 2018*, with the help of the overall global growth environment, business-friendly fiscal policy, and a healthy consumer, we believe the economy can produce a second year of growth above the 2.2% average seen during the expansion. If the economy can grow near our forecast of 2.5%, we expect the Fed to hit its mark again next year.

DOT PLOTS

The Fed's "dot plots" are the forecasts of the expected path of the Fed's policy rate by the seven members of the Fed's Board of Governors and the head of each of the 12 regional Fed banks, each represented by an (unattributed) dot.

FED VERSUS THE MARKET: ROUND THREE

What has gone wrong in prior years? Likely, the disconnect was due to a combination of unexpected events, a lack of support from global growth, and potentially Fed policy itself interfering with the business cycle (especially in more recent years). Throw in underestimating the structural forces weighing on inflation, and it's easy to see, at least in hindsight, why the Fed was aiming too high. For example, in the second quarter of 2014, the economy grew 5.2% in the second quarter, a clip not seen (before or since) in the current expansion. By the first quarter of 2015, the economy had averaged growth of 3.7% over the prior four quarters, which is a good reason for optimism. However, oil prices had begun to collapse in mid-2014, and overborrowing and overbuilding within the energy industry began to have a global impact. While lower oil prices themselves helped limit the extent of the slowdown, global credit markets tightened considerably and by the first quarter of 2016, U.S. growth had slowed to under 1.5%.

Who could have seen this slowdown coming? While the market-implied outlook, based on the fed fund futures market, did not foresee the extent of the slowdown in 2016, it has been consistently more pessimistic than the Fed. At the end of 2014, both markets and the Fed did start projecting the start of a rate hike cycle in 2015, but there has been a consistent dynamic of the market believing that the Fed would not raise rates at the pace that the Fed projected. This was likely due to a combination of factors: some skepticism about the economy's potential to break out of its low velocity path given intermittent setbacks, some skepticism about the Fed's will to raise rates more quickly, and perhaps greater weight given to the economy's inability to produce inflation at the Fed's target rate. Whatever the combination, in 2015 and 2016, the more conservative market-implied forecasts came closer to what we actually saw, although even the market-implied forecasts were also too high.

FORECASTER FOIBLES

Like the Fed and market-implied projections, forecasters in general have also tended to be too optimistic about the path of interest rates, not just in 2015 and 2016, but throughout this expansion.

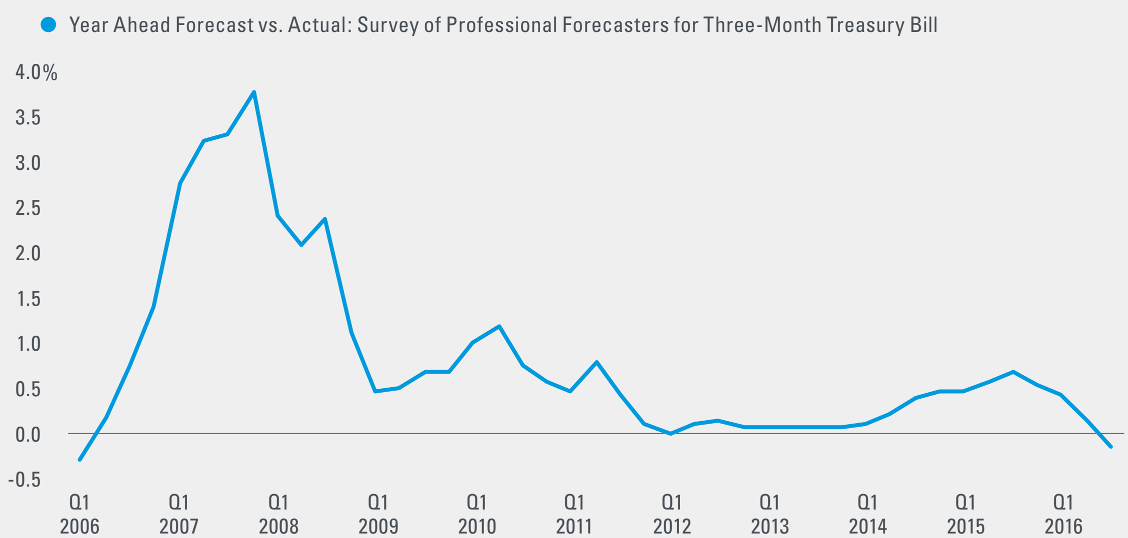
For the sake of comparison, we'll look at the year-ahead forecast for the three-month Treasury bill rate from the quarterly Survey of Professional Forecasters gathered by the Philadelphia Fed. While the forecast for Treasury bills is not the same as the fed funds rate, the fed funds rate has a large impact on short-term Treasuries and the forecast for Treasury bills reflects beliefs about Fed policy. In the third quarter of 2016 (the most recent available full-year forecast), the consensus for the year ahead was too low for the first time since the first quarter of 2006 [Figure 2]. In other words, for the entire expansion, forecasters have expected rates to revert more quickly toward long-term norms than they actually have. Whether looking at the Fed, consensus economic forecasts, or market-implied forecasts, there has been a consistent bias, until this year, to see rates pushing higher than they actually have.

CONCLUSION

In this season of forecasts, it's important to understand the value but also the limitations of attempts to peer into the future. Forecasts provide an important baseline and, for investors, they also provide information on what the market is pricing in. Some people and institutions are better at making accurate projections than others, but remember that forecasts assume that things will play out fairly normally. And while they usually do, irregular events have the potential to push things off course, and are even normal. In 2017, the economy largely behaved as expected, and when it didn't, there was a slight bias to the upside. That made for a good year for forecasts and gives us economic momentum heading into 2018. A little optimism worked in 2017 and we suspect it might again in 2018. ■

Please note, this will be our last Weekly Economic Commentary *of the year, as we will take next week off to be with our families. See you in 2018!*

2 FORECASTERS HAVE BEEN TOO OPTIMISTIC THROUGHOUT THE EXPANSION...UNTIL 2017



Source: LPL Research, Federal Reserve Bank of Philadelphia 12/15/17

Values above zero indicate the forecast was above the actual value over the forecasted time period.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in this material may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

DEFINITION

Quantitative easing (QE) is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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