LPL RESEARCH

BOND MARKET PERSPECTIVES

June 19 2018

# CENTRAL BANK REACTION RECAP

John Lynch *Chief Investment Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

## KEY TAKEAWAYS

The Fed announced a more aggressive rate hike schedule, a minor hawkish surprise to investors.

The ECB announced an end to its bond-buying program earlier than expected, but leaned dovish with a promise of no rate hikes for at least a year.

Market reaction to the meetings was benign, indicating the events were well within investors' range of expected outcomes.

**Three of the world's most influential central banks met last week, with some minor surprises emerging from two of them, evidenced by the reactions to each meeting.** The Federal Reserve (Fed), the European Central Bank (ECB), and the Bank of Japan (BOJ) all met last week, during an action-packed five days that also included several important economic data updates. The BOJ meeting was a nonevent, as expected, but the Fed and ECB gave investors some minor surprises.

## FED IN FOCUS

The Fed meeting was widely expected to have the most short-term impact on rate markets, because the ECB was not expected to raise its benchmark interest rate anytime soon. As markets anticipated, the Fed raised the fed funds rate 25 basis points (0.25%) to a new range of 1.75–2.00%. The Fed also raised its guidance for future hikes (the "dot plot"), with the median dot pointing to four hikes total in 2018 compared with three prior to this meeting. The change in expectations comes as the economy picks up steam and inflation slowly grinds higher. The Fed raised its estimates for 2018 gross domestic product (GDP) growth, lowered the unemployment estimate, and raised the inflation forecast. The hawkish change to forecasts and statement language and the tone of the press conference indicated to markets that the Fed may likely hike rates again during its September meeting, with the market currently pricing in an approximate 75% chance of a hike in September.

Market reaction was clear in direction, though unimpressive in terms of magnitude. This implies that the takeaways from the meeting were hawkish, but only slightly so, for two main reasons. First, the major change in forward-looking guidance from the Fed was the aforementioned dot plot, rising from a median of three rate hikes this year to four. The market anticipated between three and four hikes heading into this meeting, so the change from three to four pushed short-term interest rates up only modestly [Figure 1]. Second, investors are aware that the median dot plot is simply that: just a median. As outlined in our recent *Weekly Economic Commentary*, a change in opinion of just one Federal Open Market Committee (FOMC) member from three hikes to four would change the widely reported median, meaningfully altering media headlines without too much change in the underlying conviction of Fed members. This is exactly what happened, so investors who understood what's going on "under the hood" of the dot plots didn't overreact to the headline.

The presidents of regional Federal Reserve Banks are commonly classified as hawks or doves. Hawks generally favor tighter monetary policy, with less monetary support from the Federal Reserve. Doves are the opposite, generally favoring easing of monetary policy.



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## ECB DELIVERS EARLY

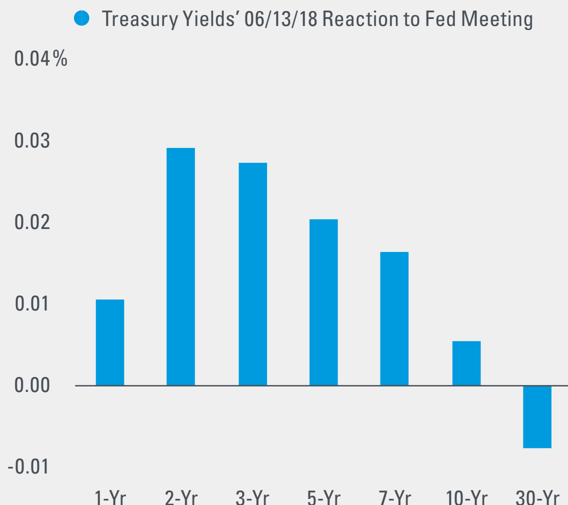
The European Central Bank (ECB) announced it would end its bond purchases (so-called quantitative easing) by year end as expected. Investors had previously expected this announcement in July, but the ECB's chief economist had tipped the ECB's hand that it may come during the June meeting. The move implies some comfort with the economic outlook in the currency union, which we would view positively despite substantial evidence that Europe's economy is slowing—on top of tariff risk. On the other hand, in a slightly dovish development, ECB Chief Mario Draghi pledged to not raise interest rates until at least summer 2019 and that the benchmark target rate will remain at zero as long as is necessary thereafter, depending on the data. This dovish-leaning message led to some modest weakness in the euro and lower European yields post-announcement, which pressed domestic yields down as well [Figure 2].

## FLATTENING CURVE

Although the reactions to these central bank announcements were different, the one thing they had in common was that they had a flattening effect on the U.S. Treasury yield curve. During the Fed announcement, rates rose, but more so in shorter maturities. Reacting to the ECB announcement, rates fell, and more so at longer maturities. Thus, although rates went higher with the Fed and lower with the ECB, they both affected the shape of the yield curve in a similar fashion.

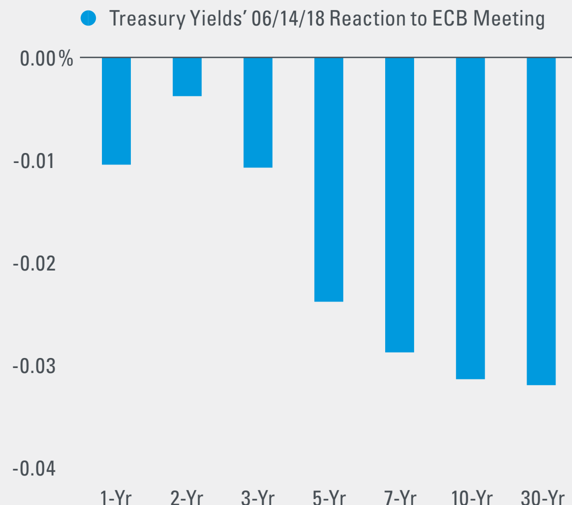
The flattening yield curve, which has puzzled many investors, has been rather relentless in recent years, except for brief respites post-election and at beginning of this year. This has come despite strengthening growth prospects recently and inflation that has been on the rise since early 2016. Part of the answer is that yields are rising across the yield curve, but more so in shorter maturities. The silver lining for investors is that a flattening yield curve in which yields are rising portends stronger

**1 SLIGHTLY HAWKISH FED MEETING PRESSED YIELDS HIGHER**




Source: LPL Research, Bloomberg 06/15/18

**2 DOVISH-LEANING ECB ANNOUNCEMENT SENT YIELDS LOWER GLOBALLY**




Source: LPL Research, Bloomberg 06/15/18

ECB: European Central Bank



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economic growth and equity market performance than a flattening yield curve with declining yields.

Another factor that could be driving the flattening is market participants not believing the Fed's stated trajectory, especially in light of the upping of rate hike forecasts in the most recent Fed meeting. Investors may believe that the stated pace of rate hikes is not sustainable. Yield curve shifts appear to imply that if the Fed goes through with hikes in 2018 and 2019 as laid out, it could have a deleterious effect on growth and inflation.

## CONCLUSION

One of the most impactful weeks for the markets this year has come and gone, with slight surprises from the Fed and ECB's meetings. Markets largely took the changes in stride, but nuanced market reaction can give a sense of the future impact that these changes may have for rate markets. The Fed leaned slightly hawkish and the ECB slightly dovish, but the muted market reaction indicates that investors were prepared for the announcements, largely due to the heavy telegraphing from central banks, which have grown weary of surprising investors. Investors also continue to take solace in the fact that the Fed and ECB remain data dependent, and can alter their stated course as economic conditions change. ■

IMPORTANT DISCLOSURES

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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. However, the value of fund shares is not guaranteed and will fluctuate.

International debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

DEFINITIONS

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semiannually and the income that holders receive is only taxed at the federal level.

Yield Curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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