LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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FOMC FAQs: WILL THE DOTS MOVE?

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KEY TAKEAWAYS

The Fed holds its second of eight FOMC meetings of 2017 this Tuesday and Wednesday, 03/14/17–03/15/17

The fed funds futures market has fully priced in a 0.25% rate hike this week.

Fed Chair Janet Yellen will hold a press conference and the FOMC will release a new set of economic forecasts and "dot plots" at this week's meeting.

We continue to expect two to three rate hikes in 2017.

WHAT IS THE SCHEDULE OF EVENTS FOR THE FED THIS WEEK?

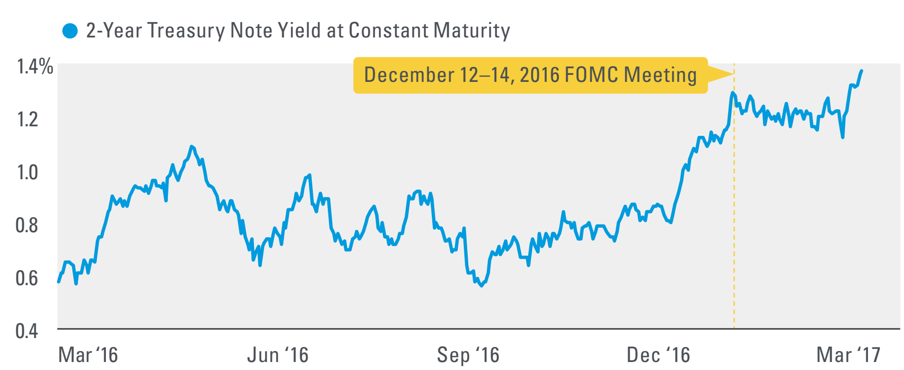
The Federal Open Market Committee (FOMC) meeting on Tuesday and Wednesday (March 14–15, 2017) will be followed by an FOMC statement at 2:00 p.m. ET on Wednesday, March 15, 2017. Along with the statement, the FOMC will also release a new set of economic forecasts (gross domestic product [GDP], the unemployment rate, inflation, and fed funds projections, also known as the "dot plots"). Fed Chair Yellen's post-FOMC meeting press conference (her first of 2017) starts at 2:30 PM ET.

HAS THE MARKET PRICED IN A RATE HIKE AT THIS WEEK'S MEETING?

In short, yes. As of Monday morning, March 13, 2017, the fed funds futures market is pricing in a 100% chance of at least a 25 basis point (0.25%) rate hike at this week's meeting, and a 2% chance of a 50 basis point hike. Of the 79 economists surveyed by Bloomberg News 75 expect a hike this week. For reference, as recently as late February 2017, the market was pricing in less than a 40% chance of a hike at this week's meeting.

Another good proxy for what the market is pricing in is the yield on the 2-year Treasury note [Figure 1] as the Treasury note is most sensitive to the Fed's actions. At 1.36% as of Monday, March 13, 2017, the yield on the 2-year note has moved up by 10 basis points since the Fed's 25 basis point rate hike on December 14, 2016. On that day, the 2-year note yield closed at 1.26%.

1 IN RECENT WEEKS, THE 2-YEAR TREASURY NOTE YIELD HAS BEGUN PRICING IN A RATE HIKE IN MARCH



Source: LPL Research, U.S. Treasury, Haver Analytics 03/13/17

Performance shown is historical and no guarantee of future results.

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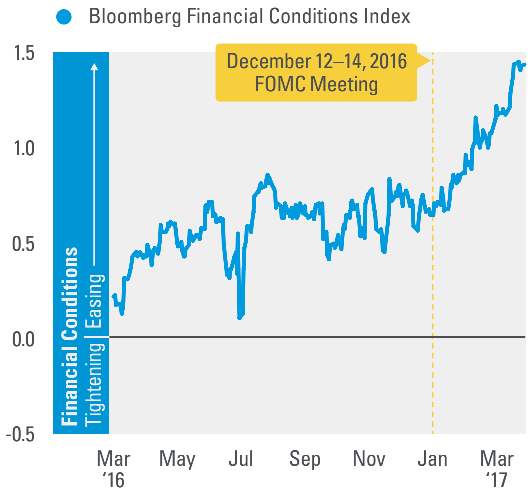
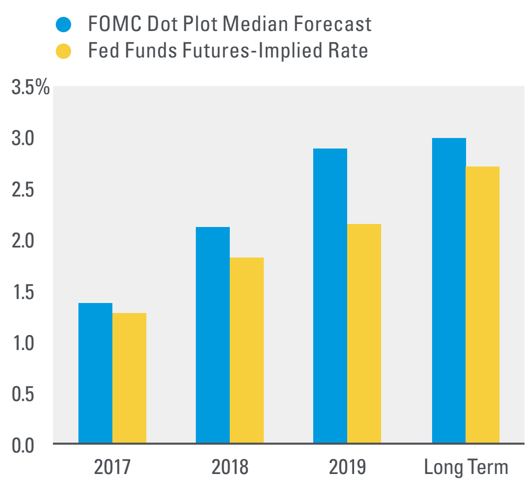
2 **FINANCIAL CONDITIONS HAVE EASED IN RECENT WEEKS, AND ARE NEAR BEST LEVELS IN MORE THAN 10 YEARS**



Source: LPL Research, Bloomberg 03/13/17

The Bloomberg U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. It is an undamaged index and cannot be invested into directly.

3 **A NEW SET OF DOT PLOTS AT THIS WEEK'S MEETING MAY OPEN UP A GAP BETWEEN THE MARKET AND THE FED**



Source: LPL Research, Federal Reserve 03/13/17

The market-implied chances of a rate hike are calculated based on pricing of various fed funds futures contracts.

Forecasts may not develop as predicted.

HOW HAVE FINANCIAL CONDITIONS CHANGED SINCE THE LAST FED RATE HIKE?

Financial conditions, as measured in Figure 2 by the Bloomberg Financial Conditions Index, have eased considerably since the last Fed rate hike in December 2016, and now stand very close to their most accommodative levels in more than 10 years (late 2005/early 2006). With the economy close to full employment and inflation near the Fed's 2% target, by raising rates by 25 basis points this week, the Fed could argue that it is simply acting to be sure that the economy doesn't overshoot its goals.

HOW LARGE IS THE DISCONNECT BETWEEN THE FED AND THE MARKET ON RATES?

The FOMC's latest forecast (December 2016) puts the fed funds rate at 1.375% by the end of 2017. The FOMC will release a new set of "dot plots" at the conclusion of this week's meeting. The market (according to fed funds futures) puts the fed funds rate at around 1.34% by the end of 2017 [Figure 3], very close to the Fed's own projections (1.375%). The latest set of dot plots from the Fed puts the fed funds rate at 2.125% by the end of 2018, while the market currently expects the fed funds rate to be 1.75% at year-end 2018, a 37 basis point difference. So, while not perfectly aligned—the FOMC and the market are rarely ever perfectly aligned on the future path of rates—there is general agreement between the Fed and the market.

This "agreement" between the Fed and the market is relatively new. In early 2016, just after the Fed's first rate hike of the cycle in December 2015, the FOMC's dot plots implied eight 0.25% rate hikes in 2016 and 2017. The market expected just two 0.25% hikes. That large disconnect between the market and the Fed was one of the root causes of the imbalances that plagued global financial markets in late 2015 and the first few months of 2016. Clearly, no such disagreement is evident today.

However, at this week's meeting the FOMC may collectively choose to raise its forecasts for the fed funds rate at year-end 2017, 2018, 2019, and in the long run; but if it does, it risks opening up another gap between the Fed and the market.* In our view, while a few, individual FOMC members may move up their forecasts for the fed funds rate at this week's meeting, the median dot plot for year-end 2017, 2018, and 2019 is likely to stay where it was in the December 2016 dot plots.

WHAT SHOULD WE EXPECT FROM YELLEN'S Q&A

Although fiscal policy is not likely to be mentioned in the FOMC statement, Yellen will likely mention fiscal policy in her opening statement to the press conference as she did at her press conference at the conclusion of the December 2016 FOMC meeting, and she is very likely to get at least a few questions about the impact of potential fiscal policy on the Fed's monetary policy deliberations. She received at least five questions on fiscal policy at her press conference following the December 2016 FOMC meeting, and fiscal policy was, of course, a key line of questioning from members of Congress at Yellen's mid-February 2017 monetary policy testimony. The Fed (and the markets) remains unclear about the timing, scale, and specifics of fiscal policy, and Yellen will likely cite those uncertainties as she answers those questions.

In addition to fiscal policy, other potential topics Yellen may be asked about include, but are not limited to:

- The Fed's balance sheet,
- Whether or not she thinks the Fed is "behind the curve" on inflation,
- The Fed's independence from Congress and President Trump,
- Yellen's own job security,
- Vacancies on the Fed's Board of Governors,
- Financial regulation,
- The stock market,
- International trade policy under President Trump

WHAT'S NEXT FOR FED WATCHERS?

Yellen is scheduled to deliver a speech at a community development conference in Washington, D.C. on March 23, 2017, but that seems like a very unlikely venue for the Fed Chair to make any news on monetary policy. The minutes of this week's FOMC meeting are due out on April 5, 2017, and are likely to provide some detail on what committee members were thinking regarding fiscal policy should Yellen decide to evade the question at her press conference this week. The next Beige Book—a qualitative assessment of economic, financial, and banking conditions in each of the Fed's 12 regions—is due out on April 19, 2017, and the next FOMC meeting is on May 2–3, 2017. The FOMC won't release a new set of economic forecasts or dot plots at that meeting, and currently, there is no Yellen press conference scheduled for that meeting. The next key event for the Fed and Fed watchers may simply be tracking what is happening in Congress with the potential legislation on tax cuts and infrastructure spending. ■

*Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy.

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 referenced is historical and is no guarantee of future results.

Any economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

The Federal Open Market Committee (FOMC) is the branch of the Federal Reserve Board that determines the direction of monetary policy. The eleven-person FOMC is composed of the seven-member board of governors, and the five Federal Reserve Bank presidents. The president of the Federal Reserve Bank of New York serves continuously, while the presidents of the other regional Federal Reserve Banks rotate their service in one-year terms.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal and potential illiquidity of the investment in a falling market.

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.

The Fed Funds futures contract represents the average daily fed funds effective rate for a given calendar month as calculated and reported by the Federal Reserve Bank of New York. It is designed to capture the market's need for an instrument that reflects Federal Reserve monetary policy.

The Bloomberg U.S. Financial Conditions Index tracks the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms.

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