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INVESTMENT MANAGERS

Investment Viewpoint

Jackson hole: what to watch out for

Asset Management

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As the last weekend in August approaches, central bankers are readying themselves for a retreat in the beautiful Jackson Hole, Wyoming - host to the annual Kansas City Fed symposium. A forum for informal discussion among central bankers, the symposium is not intended as a tool to influence monetary policy expectations. Yet on occasion it has done precisely that, sending ripples through the market. Recall Ben Bernanke paving the way for further quantitative easing at the 2010 event, and Alan Greenspan's talk of 'irrational exuberance' in 1999. What might this year have in store?

The headline acts

This year's theme is 'Fostering a Dynamic Global Economy' and the key speakers to watch are chairman of the Federal Reserve, Janet Yellen, and President of the ECB, Mario Draghi. Yellen's chosen topic is financial stability. This may seem an odd choice considering the theme of the symposium, but putting that aside we explore two potential angles that we think Yellen might take in her speech, each with contrasting implications for market reactions.

Yellen's option 1 – calm assured

Yellen could decide to lay out the need for sound financial regulations and underscore the importance of well-capitalised banks as a way to avoid excess and mitigate the risk of destabilising shocks to the economy. Such a speech would likely have little-to-no market impact, in our view.

Yellen's option 2 – watch for waves

The more interesting way in which Yellen may try to link the issue of financial stability to the event's main theme would be via a discussion on how financial stability is linked to monetary policy. Here we think there is potential for Yellen to articulate a more hawkish view, and this could rock markets.

We believe that the Fed may be shifting its views regarding the impact of loose monetary policy on the economy by turning its attention to asset prices. In late June, both Chair Yellen and Vice-Chair Fischer commented that the valuations of certain asset classes were "somewhat rich" and we would not be surprised if such observations were repeated.

This could be significant. As we wrote **in our recent piece,** the Fed's concerns over excessive asset valuations are linked to the issue of increased risk appetite leading to more risk-taking and leverage, which in turn increases the vulnerability of financial markets – thus creating a threat to financial stability.

Learning from their experience of the tightening cycle of 2004-2006, the Fed is likely to be concerned that if it does not tighten monetary policy soon enough it may sow the seeds of financial instability. During that period, financial conditions in the US actually loosened even as the Fed tightened; a situation that is very similar to what we are experiencing in the current hiking cycle (financial conditions are currently looser than they were before the first hike in September 2015).

If Yellen's assessment follows these lines, this could indicate to the market that moves to begin to reduce the size of the Fed's balance sheet are imminent, and it would also support the FOMC's view that the pace of rate hikes will be much quicker than the market expects. The Fed expects the policy rate to be between 2.00% and 2.25% by the end of 2018 and between 2.75% and 3.00% by the end of 2019, while the market consensus puts rates at almost 1.45% and 1.55% respectively. A scenario in which – despite weak inflation – Yellen supports the need for a higher policy rate owing to financial stability concerns, could force a repricing of the US rate curve, where investors are clearly underpricing the probability of a faster pace of the removal of policy accommodation.

Draghi – straight talking, but in which direction?

The topic of ECB President Draghi's speech has yet to be released, which makes it difficult to predict any possible market impact. Nevertheless, Draghi is known to speak his mind at this and similar events, often in contrast to his more guarded communication style when, say, he represents the Governing Council (i.e. at ECB press conferences or to the European Parliament). Examples include his London speech in 2012 when he said that the ECB would "do everything it can to save the Euro" and, more recently, his comments in his speech at Sintra where he made relatively hawkish noises.

Draghi's comments at Sintra suggested he is likely more hawkish than the median view of the Governing Council. We would not be surprised if he shows his support for the removal of the dovish bias from the monetary statement or gives some hints of his preference for an ECB tapering announcement in coming months. However, if he does so, we think he is also likely to remind markets that any reduction in the level of policy accommodation will depend on how financial conditions evolve; basically that continued Euro appreciation could delay the reduction in policy accommodation. This would be a way for Draghi to try to talk down the currency.

Our expectations for monetary policy

In the US, we expect the FOMC to announce the start of the reduction in the Fed's balance sheet at the September meeting and we would not be surprised if the Fed hikes rates at the December meeting.

In Europe, we believe that the ECB will be much more patient with regard to monetary policy tightening. We think it is possible that Draghi is more supportive of policy normalisation than the median member of the Governing Council, meaning that the Governing Council is likely to be more patient over tapering than Draghi's speech today may suggest. This differing of views (Draghi versus the rest of the ECB Governing Council) might explain why Draghi seemed to signal a more neutral policy in his Sintra speech while the ECB's July communiqué retained a dovish bias.

Nevertheless, we believe that the ECB is likely to announce a very gentle tapering of its asset purchase program this autumn, but the exact timing will likely depend on the value of Euro. As for rate hikes, we firmly believe they are not on the table and are unlikely to be a subject of discussion until early 2019.

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