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Illumination from Jackson Hole?

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The US Fed has persistently indicated that the normalization of monetary policy would be gradual. This strategy takes account of the risks of reacting too late or too early. Markets currently appear to be assuming that the Fed's main fear is that further rate hikes could prove to be premature. It would certainly be helpful if Janet Yellen were to crystallize the Fed's normalization strategy once again in her speech in Jackson Hole. We think a further hike in the key rate is warranted. Positive economic numbers for the third quarter, rising wages and a brighter global backdrop all argue in favor of such a move.

The recent softness of the US dollar and yields on 10yr Treasuries of only 1.5% for a while now suggest that the financial markets see little likelihood of further monetary policy normalization in the near future. Indeed, on the federal funds futures market a further rate hike was of late not fully priced in until July 2017. And yet the economic data are not out of kilter with the trend outlined for 2016 by the Fed in its June projections.

The reasoning behind subdued rate hike expectations are probably manifold. Among other things, the markets appear to have concluded from recent Fed communication that the central bank fears that further rate moves could prove premature.

On the one hand the discussion documented in the minutes of the FOMC meeting in July might have created the impression that the Fed was keen to

wait with further rate hikes until inflation has picked up substantially. Against this backdrop, a paper by the president of the Federal Reserve Bank of San Francisco, John Williams, in which he discussed inter alia the option of pursuing a somewhat higher inflation target, attracted great attention.

Tellingly, in a recent speech the central banker nevertheless argued for a gradual normalization of key rates. Strikingly, he also presented arguments against waiting too long, i.e. until inflation has reached 2% or even more. Highlighting overinvestment in tech-related industries in the late 1990s and in the residential real estate sector in the middle of the last decade, he stressed the additional potential risks of keeping monetary policy too loose for too long. Overall, these statements are consistent with the current normalization strategy aimed at changing course gradually and thus weighing up the risks of reacting too early as well as too late. They are also in line with recent statements by other Fed representatives that rate hikes might be appropriate this year.

It would certainly be helpful if Janet Yellen were to emphasize this expectation management prominently in her Jackson Hole speech. This would presumably prompt corrections on the markets. But these would probably be far less severe than those seen for instance in mid-2013. At that time hints by then Fed president Bernanke that the Fed might reduce its asset purchases caught the markets off guard, sending government bond yields up sharply in a short space of time. In our view, a further hike in the key rate is warranted. Positive economic numbers for the third quarter, rising wages and a brighter global backdrop all argue in favor of such a move.

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