What Action, Post-Jackson?

Douglas Porter, CFA
Chief Economist
douglas.porter@bmo.com
416-359-4887

Jennifer Lee
Senior Economist
jennifer.lee@bmo.com
416-359-4092

For many of the central bankers gathering for this year's annual Jackson Hole Symposium in Wyoming, the challenges look very different from just a few short months ago. Trade tensions have transitioned into open skirmishes, some emerging market weaknesses have boiled over, higher oil prices have lifted headline inflation trends, and borrowing costs generally have risen from the ashes. As a result, last year's synchronized, surprisingly strong global economy has given way to much more divergent growth trends, with cooler activity in many key regions. Even as the U.S. has gathered momentum amid heavy-duty fiscal stimulus, activity in Europe, Japan and China has faded. For example, U.S. GDP is poised to handily outpace the Euro Area this year and next after trailing slightly in the past two years (*Chart 1*). Below, we consider how the major central banks will deal with this more complex backdrop.

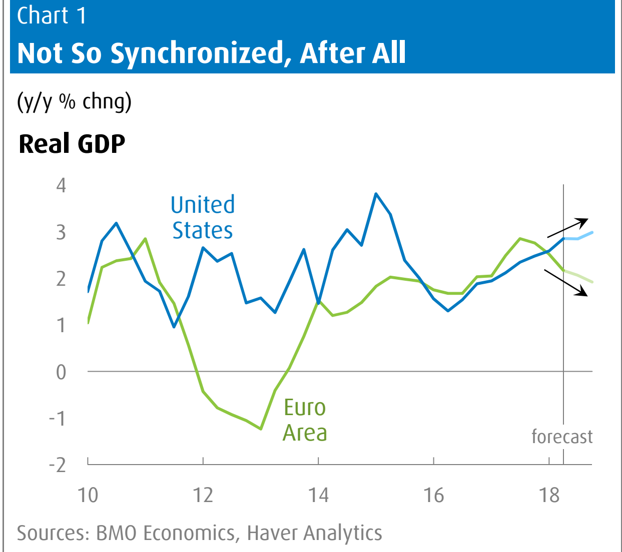
Federal Reserve

Top Concern: Flattening yield curve
Emerging Concerns: Trade, Trump, Turkey

Despite the wide variety of concerns listed above, we believe that the Fed is still on a path to gradually drive short-term rates back toward longer-run neutral (i.e., 100 bps higher than the current 1.875%). And that likely means a continuation of one rate hike per quarter until mid-2019 (with the next move in late September), unless something huge unfolds in the meantime such as emerging market turmoil spreading beyond Turkey. Trump's latest verbal volleys at Chairman Powell are unlikely to have much impact on actual policy, although they could make Fed messaging a bit more critical.

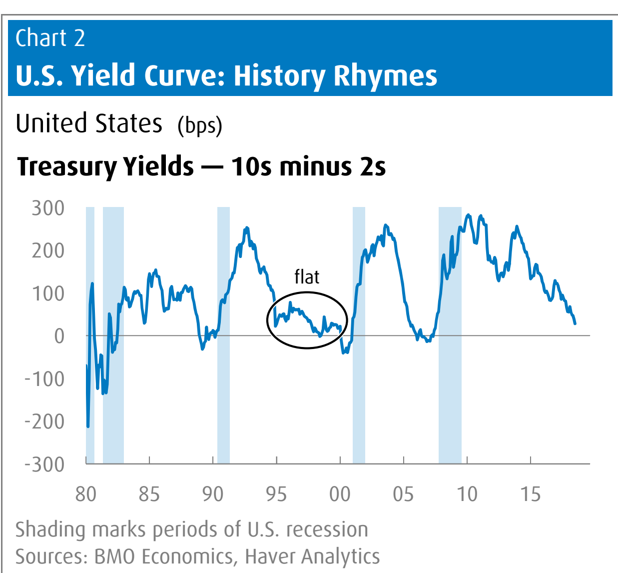
Trade tiffs will dampen U.S. growth, but will also put a bit more upward pressure on prices, and thus could be almost a wash for the Fed. So, ultimately, **the biggest constraint on Fed rate hikes could be the market itself**; i.e., the stubborn refusal of long-term bond yields to gravitate out of the 2.80%-to-3.00% range. The Fed's focus on the flat yield curve has intensified, with a variety of speakers and the FOMC minutes highlighting the issue just this week. We will simply reiterate what we have said many times—one must respect the signal from the yield curve. But, it has lost some of its predictive power due to the lower term premium, and flattening is not an issue until the curve actually inverts (note the late 1990s in *Chart 2*).

Chart 1
Not So Synchronized, After All



Sources: BMO Economics, Haver Analytics

Chart 2
U.S. Yield Curve: History Rhymes



Shading marks periods of U.S. recession
Sources: BMO Economics, Haver Analytics

European Central Bank

Top Concern: Ending QE
Emerging Concerns: Italy, Trade

The ECB began the year with plans to *"revisit"* its policy stance and forward guidance, and as inflation headed toward the 2% target and growth remained firm, the central bank turned its attention to **adjusting policy without being too disruptive** to markets. For example, it didn't want to further stoke the euro after last year's 14% rise by being too hawkish. And it succeeded. After some initial

prepping in the spring, the end date for QE was announced in June, along with a broad statement about a possible 2019 rate hike. There was enough caution and vagueness, thanks to cooler growth (*Chart 3*), to keep a lid on interest rates and the euro. We see QE ending this year, and a rate hike next year in September.

But **protectionist threats** are a growing concern. And, **Italy** could be disruptive. The new government's fall budget will likely contain plenty of spending with little to offset. The resulting deficit will blow past the 3%-of-GDP cap, setting up a tussle with the EU. If Italy is downgraded and borrowing costs surge, it will be difficult for the ECB to stay on its path to end QE, let alone begin hiking in 2019.

Bank of England

Top Concern: Brexit
Emerging Concern: No Brexit deal

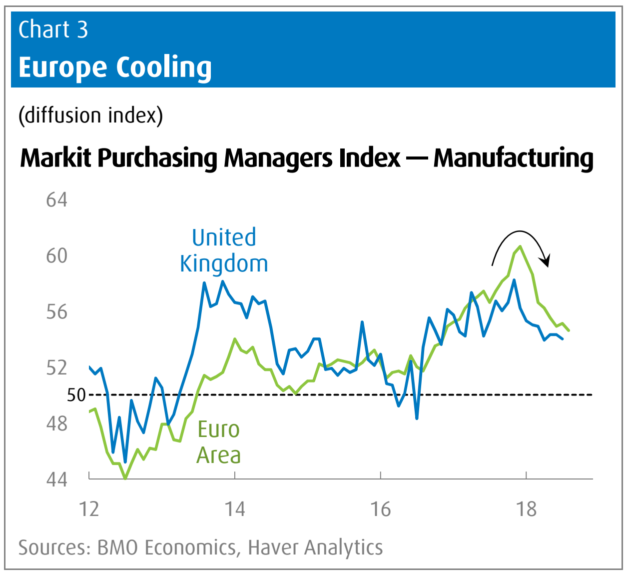
No one ever said **Brexit** would be easy. The take at the start of 2018 was that the tough negotiations would eventually give way to some sort of an agreement; perhaps, at worst, with a longer transition period. Still, there was an ominous sign from Brussels, when regulators released *"be prepared"* memos to the private sector last year. Some would even say that the EU was negotiating with a hard-Brexit scenario in mind.

Now, **fears of a cliff-edge Brexit abound**, reflected in a sagging British pound. Despite these relentless concerns, the BoE seized on firming inflation pressures (*Chart 4*), a tight labour market, and widespread evidence of little economic slack, and raised rates in August (following last November's initial hike). The BoE is likely to move to the sidelines now, given that the official Brexit date is fast approaching (March 2019). However, the weak pound could push inflation higher sooner, putting Governor Carney in a tough spot: abiding by the inflation mandate while also trying to shield the economy from any negative blow from a hard Brexit. We suspect the latter concern will dominate for the next six months.

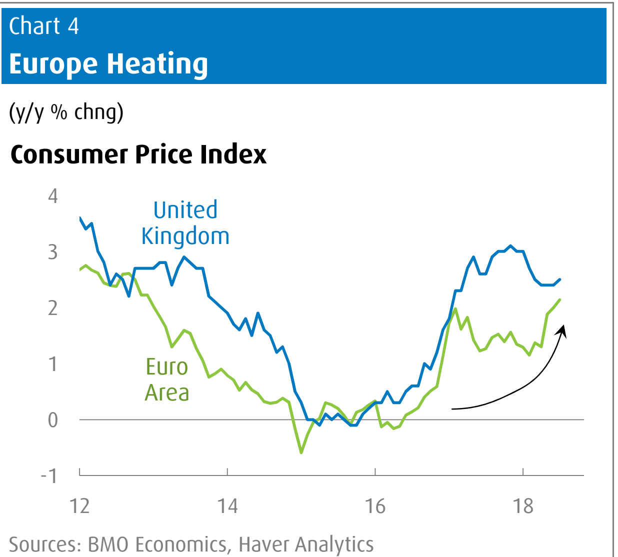
Bank of Japan

Top Concern: Moving away from zero
Emerging Concern: Fading inflation

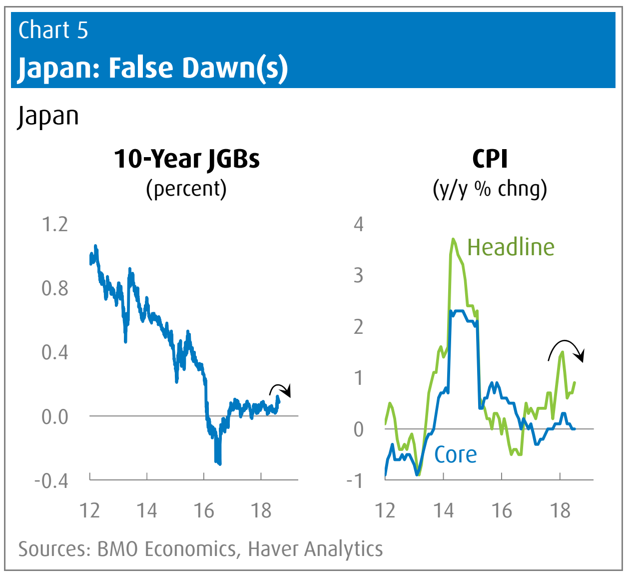
The BoJ's biggest concern has been navigating interest rates away from zero. Such low rates were ushered in by radical easing measures and a deflationary mindset that continues to grip the country. Inflation was finally edging higher earlier this year, with headline CPI at a 3-year high of 1.5% in February (*Chart 5*). This prompted some to expect Governor Kuroda to give an exit signal—even if far off in the future. Unfortunately, inflation has since headed lower (headline and core), fading along with hopes of tighter BoJ policy. Simply, we expect no significant change in policy for the foreseeable future.



Sources: BMO Economics, Haver Analytics



Sources: BMO Economics, Haver Analytics



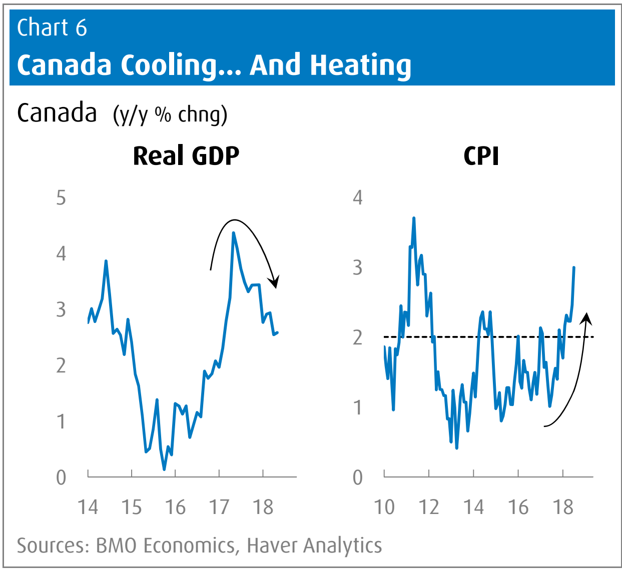
Sources: BMO Economics, Haver Analytics

Bank of Canada

Top Concern(s): NAFTA/Household Debt
Emerging Concern: Inflation

In contrast to many other banks, there is a sense of déjà vu for the Bank of Canada this August. Exactly a year ago, there was some speculation that the Bank could hike rates for a second consecutive meeting following a summer of stronger-than-expected data, even amid NAFTA uncertainty—and the rest is history. But there are three key differences this time: 1) Last year's move simply completed a reversal of the emergency oil shock cuts; 2) the Bank has stressed since the start of the year that it will move gradually; and, 3) after last year's summer of silence, Governor Poloz is speaking at this year's Jackson Hole Symposium.

Despite the frenzy of rumours about a deal with Mexico, **NAFTA remains as much of a wild card as ever** for Canada—with the country specifically singled out for possible auto tariffs by the President. On the other major risk, we have a much calmer and clearer backdrop for the previously erratic housing market. **Household debt growth has cooled notably** over the past year, with the closely-watched debt/income ratio finally fading. But just as that potential driver of higher rates has calmed, **headline inflation has abruptly stepped up to the plate**, swatting the highest inflation rate in the industrial world in July (at 3.0%, tied with Norway; *Chart 6*). While core is stable at 2.0%, the uptick does keep the Bank in play at its September decision. Our view is that, with trade negotiations still potentially unravelling and housing becalmed, there is no urgency for the Bank to hike, so we see an October move, with at least two more hikes in 2019. If an agreement can be reached on NAFTA, the risks for faster rate hikes skew immediately higher—we just remain highly sceptical that Canada can soon agree to a deal.



General Disclosure

"BMO Capital Markets" is a trade name used by the BMO Financial Group for the wholesale banking businesses of Bank of Montreal and its subsidiaries BMO Nesbitt Burns Inc., BMO Capital Markets Limited in the U.K. and BMO Capital Markets Corp. in the U.S. BMO Nesbitt Burns Inc., BMO Capital Markets Limited and BMO Capital Markets Corp are affiliates. This document is issued and distributed in Hong Kong by Bank of Montreal ("BMO"). BMO is an authorized institution under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) and a registered institution with the Securities and Futures Commission (CE No. AAK809) under the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong). BMO does not represent that this document may be lawfully distributed, or that any financial products may be lawfully offered or dealt with, in compliance with any regulatory requirements in other jurisdictions, or pursuant to an exemption available thereunder. This document is directed only at entities or persons in jurisdictions or countries where access to and use of the information is not contrary to local laws or regulations. Their contents have not been reviewed by any regulatory authority. Bank of Montreal or its subsidiaries ("BMO Financial Group") has lending arrangements with, or provide other remunerated services to, many issuers covered by BMO Capital Markets. The opinions, estimates and projections contained in this report are those of BMO Capital Markets as of the date of this report and are subject to change without notice. BMO Capital Markets endeavours to ensure that the contents have been compiled or derived from sources that we believe are reliable and contain information and opinions that are accurate and complete. However, BMO Capital Markets makes no representation or warranty, express or implied, in respect thereof, takes no responsibility for any errors and omissions contained herein and accepts no liability whatsoever for any loss arising from any use of, or reliance on, this report or its contents. Information may be available to BMO Capital Markets or its affiliates that is not reflected in this report. The information in this report is not intended to be used as the primary basis of investment decisions, and because of individual client objectives, should not be construed as advice designed to meet the particular investment needs of any investor. This document is not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such Information be considered as investment advice or as a recommendation to enter into any transaction. Each investor should consider obtaining independent advice before making any financial decisions. This document is provided for general information only and does not take into account any investor's particular needs, financial status or investment objectives. BMO Capital Markets or its affiliates will buy from or sell to customers the securities of issuers mentioned in this report on a principal basis. BMO Capital Markets or its affiliates, officers, directors or employees have a long or short position in many of the securities discussed herein, related securities or in options, futures or other derivative instruments based thereon. The reader should assume that BMO Capital Markets or its affiliates may have a conflict of interest and should not rely solely on this report in evaluating whether or not to buy or sell securities of issuers discussed herein.

Dissemination of Research

Our publications are disseminated via email and may also be available via our web site http://economics.bmocapitalmarkets.com. Please contact your BMO Financial Group Representative for more information.

Conflict Statement

A general description of how BMO Financial Group identifies and manages conflicts of interest is contained in our public facing policy for managing conflicts of interest in connection with investment research which is available at http://researchglobal.bmocapitalmarkets.com/Public/Conflict_Statement_Public.aspx.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

BMO Financial Group (NYSE, TSX: BMO) is an integrated financial services provider offering a range of retail banking, wealth management, and investment and corporate banking products. BMO serves Canadian retail clients through BMO Bank of Montreal and BMO Nesbitt Burns. In the United States, personal and commercial banking clients are served by BMO Harris Bank N.A., Member FDIC. Investment and corporate banking services are provided in Canada and the US through BMO Capital Markets. BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A, BMO Ireland Plc, and Bank of Montreal (China) Co. Ltd. and the institutional broker dealer businesses of BMO Capital Markets Corp. (Member SIPC), BMO Nesbitt Burns Securities Limited (Member SIPC) in the U.S., BMO Nesbitt Burns Inc. (Member Canadian Investor Protection Fund) in Canada, Europe and Asia, BMO Capital Markets Limited in Europe, Asia and Australia and BMO Advisors Private Limited in India.

"Nesbitt Burns" is a registered trademark of BMO Nesbitt Burns Inc., used under license. "BMO Capital Markets" is a trademark of Bank of Montreal, used under license. "BMO (M-Bar roundel symbol)" is a registered trademark of Bank of Montreal, used under license.

® Registered trademark of Bank of Montreal in the United States, Canada and elsewhere.

™ Trademark Bank of Montreal in the United States and Canada.

© COPYRIGHT 2018 BMO CAPITAL MARKETS CORP.

A member of BMO Financial Group