GLOBAL LONG-TERM UNCONSTRAINED

Monthly Market Update

MARTIN CURRIE
A Franklin Templeton Company

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Jackson's Five

Five key takeaways from Jackson Hole conference

In this month's market insights, we review August's Jackson Hole gathering of central bankers

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This year's Jackson Hole symposium was focusing on "Structural shifts in the Global Economy", and we highlight the five key takeaways from an investor's point of view.

Whilst central bankers had the opportunity to interact amongst themselves during the usual annual gathering at Jackson Hole, there were also media interactions, with the market aiming to interpret some of the comments made by key central bankers.

There was something for both bulls and bears in terms of monetary policy comments. Our five key take-always from an investment point of view are summarised below, with more details in the report:

5 key take-always for investors from the Jackson Hole gathering:

1. **We are now in reactive monetary policy mode:** Central bankers have shifted into data dependency, so their next interest rate moves will be determined by various data points they deem to be relevant in predicting inflation.
2. **Data dependency mode will bring higher market volatility:** We expect more elevated volatility, as market participants guess and debate which data might be relevant to pay attention to, and in turn react.
3. **Central bank models are being challenged, which exacerbates volatility:** Central bankers are acknowledging the limitations of their existing economic models, which further exacerbates unpredictability, and will therefore likely further fuel market volatility.
4. **Hawks focusing on elevated inflation comments:** Hawks will focus on central bankers' comments that relate to more work still needing to be done to tackle the elevated inflation levels.
5. **Doves focusing on comments around restrictive policies**: Doves will focus on Jay Powell's (Chairman of the US Federal Reserve) comment that interest rates have now moved to a level that is well above neutral, pointing to a restrictive monetary policy, and therefore speculating that we might have reached the end of the hiking cycle.

Our conclusions:

- We are closer to the end of the hiking cycle, which in our view should be more supportive for Quality Growth stocks.
- We expect an end to the hiking cycle by the end of this year, with potentially only 0-2 more hikes to come from both the US Federal Reserve (Fed) and the European Central Bank (ECB).
- Market expectations of a rapid pivot towards interest rate cuts in H1 2024 is premature however, given what we believe will be stickier inflation – we do not expect a pivot by key central banks until H2 2024.
- As flagged in our mid-year update, the divergence in monetary policies between western Central Banks, and some Asian/emerging market (EM) central banks could become more apparent over the next six months. Western central banks will likely delay pivoting until H2 2024, while some of the Asian/EM Central Banks are already pivoting.

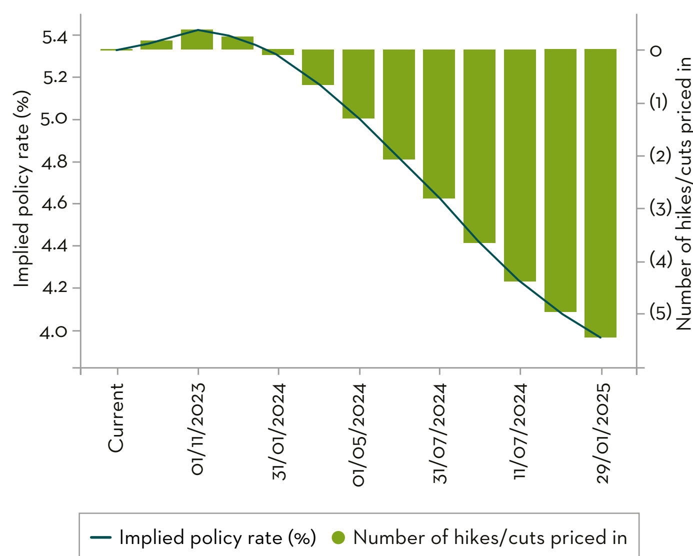
Central bankers have moved into data-dependency, as they stated both prior and during the gathering. This is likely to mean that further hikes will be dependent on the various data points that will come out, specifically those they deem to be relevant to their so-called “inflation watching”. Whilst this doesn’t mean that all data will be relevant to their reflections on the next steps to take in terms of monetary action, it will lead to a higher degree of market volatility. This is because investors and market commentators will speculate on which data is both relevant, and the important focal point.

At the same time, inflation remains the more important focus for all central bankers, away from economic growth, with many views being expressed in the past that it is easier to reignite some growth, than to extinguish inflation if it becomes a more structural phenomenon. As such, it is likely that central banks will remain vigilant, and less willing to reverse course too rapidly in our view.

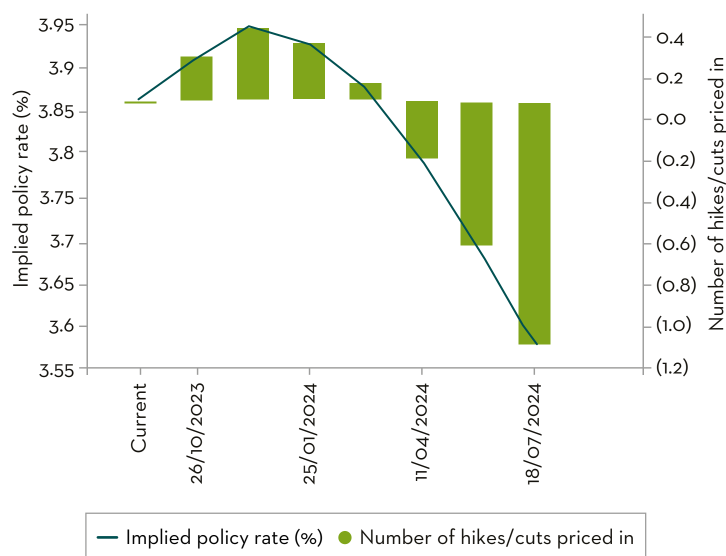
We maintain our view that inflation could end up being stickier than the market expects, and therefore central banks might be slow to reverse the hiking cycle. Whilst we are likely to see a deceleration in inflationary pressures in H2, notably as a result of the elevated base effect of last year, we do not share the market view that central banks will pivot rapidly in H1 2024. The charts below show the current market expectations of interest rate hikes/cuts for the Fed and the ECB. We might be nearing the end of the hiking cycle, but a pivot might take longer than current market expectations predict. This debate around when and how rapidly will central banks pivot will remain important for the market and for shorter term market participants. Fuelling further volatility, with each macroeconomic and microeconomic data point that might be deemed to be relevant.

Central bank policy rates versus rate hikes/cuts

US Federal Reserve



European Central Bank



Source: Bloomberg, 15 September 2023.

On the margin, at the Jackson Hole gathering, Jay Powell sounded a bit more hawkish about prospects for inflation in the nearer term. Although he seemed to also have an eye on the long end of the yield curve, through a comment that real rates were “well above neutral levels now” (something that he swiftly acknowledged as not being a reliable estimate). This might be an important point to focus on, as it is the first time that Powell has explicitly acknowledged that monetary policy is now restrictive. He did emphasise that the Fed intends to “hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective”. He used the word “restrictive” when describing current monetary policies on a more than few occasions in his speech – in fact, the word was mentioned seven times in his approximately eight minute address.

Christine Lagarde (President of the European Central Bank) remained hawkish in her tone too, whilst also acknowledging that there is a shift to data dependency. She mentioned that progress is being made on the inflation front, but added that "the fight against inflation is not yet won". She also flagged that there are concerns around a tight labour market raising more risks of persistence in inflation, flagging that "a surge in inflation can trigger catch up wage growth which can lead to a more persistent inflation process"; this is in line with our conclusion from our report back in October 2022, entitled "All eyes on wage inflation".

Given the ECB's sole focus, as part of her mandate on inflation, and given the elevated inflation level, it is perhaps not a surprise that Christine Lagarde only mentioned the word "restrictive" once in her speech, which could be pointing to a more hawkish stance.

In fact, as time of writing this report the ECB raised rates by a further 25bps at its September meeting to 4.5%.

Other points that came out of the Jackson Hole gathering include:

- Central bankers are questioning the economic models used by central banks for predicting outcomes:
  - *"Navigating by the stars under cloudy skies"* – Jay Powell
  - "*Past regularities may no longer be a good guide for how the economy works*" – Christine Lagarde
  - *"Policy making in an age of shifts and breaks requires an open mind and a willingness to adjust our analytical frameworks in real-time to new developments"* – Christine Lagarde
- Tight labour market raises risks of persistence in inflation:
  - *"A surge in inflation can trigger catch up wage growth which can lead to a more persistent inflation process"* – Christine Lagarde

Ongoing elevated inflation, interest rates remaining higher for longer than expectations, and a more volatile market environment, has reinforced our conviction in the type of companies that investors should continue to focus on. These have the following characteristics:

- **Earnings resilience,** given the ongoing risk of earnings downgrades
- **Pricing power**, given the elevated and stickier inflation
- **Balance sheet strength**, given the higher interest rates environment
- **Structural growth prospects**, given that higher rates is likely to lead to a lower economic growth

We covered the importance of pricing power in an elevated and stickier inflation environment in a recent report. Here we discussed how to assess pricing power in a company, the systematic fields that we research as part of that, and we compared our strategies' pricing power to the broader market, using gross margins trends as an indication of pricing power. Our readers can find the link to the report *here*.

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