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## Federal Reserve

Fed Chair Jay Powell delivered a largely hawkish message. But I believe those comments were mainly for show — I don't expect the Fed to hike rates again.

## European Central Bank

ECB President Christine Lagarde said that central bankers need to talk about forecasts in a more contingent way and provide better explanations for errors.

## Over or under?

One interviewee seemed to imply that under-tightening by the Fed could be worse than over-tightening. But I think that would be a mistake given so much economic uncertainty.

# Central bankers stick to the script at Jackson Hole

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The long-awaited Kansas City Fed Economic Symposium at Jackson Hole took place last week. This is one of the “must see” events for economists and market watchers, like the Sintra conference in Portugal. As I explained to my oldest son, a budding screenwriter, “It’s like a glamorous, star-studded awards show — but for economists instead of filmmakers.” To carry that analogy a bit further, here is a silver screen-inspired recap of the Jackson Hole Symposium:

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## The Fed casts itself as ‘The Terminator’ of inflation

Federal Reserve (Fed) Chair Jay Powell delivered on his expected script by providing a largely hawkish message. No, I don’t believe the Fed will hike rates again, but Powell has to talk tough, which is what he did. Let’s just say he tried to drive home the view that he is “The Terminator” of inflation.

Powell acknowledged at the start that he would give a longer speech than last year (almost double the time he used in 2022) but with the same message: “At last year’s Jackson Hole symposium, I delivered a brief, direct message. My remarks this year will be a bit longer, but the message is the same: It is the Fed’s job to bring inflation down to our 2 percent goal, and we will do so.”<sup>1</sup>

He made it clear that “...although inflation has moved down from its peak... it remains too high” and that the Fed is “attentive to signs that the economy may not be cooling as expected.”<sup>1</sup> Powell said that consumer spending has been robust and that the housing sector is showing signs of picking back up. These trends, he stated, “could warrant further tightening of monetary policy.”<sup>1</sup> This concept of using what he sees in the rearview mirror as the basis for further tightening would normally worry me — but I’m confident it is largely bluster, intended to tamp down any premature easing of financial conditions. After all, he recognized the “uncertainty about the duration of the lags with which monetary tightening affects economic activity and especially inflation.”<sup>1</sup> And that should inspire patience.

He also laid out markers for what would cause further Fed tightening:

More evidence of persistently above-trend growth

Evidence that easing in the labor market has stopped

He concluded by giving us reasons for the Fed to be cautious: “we are navigating by the stars under cloudy skies.”<sup>1</sup>

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## The ECB looks “Back to the Future” at the changing global economy

European Central Bank (ECB) President Christine Lagarde focused her speech on the theme of the conference: structural shifts in the global economy. She contemplated what the future might hold, recognizing that there are three shifts impacting the economy: the labor market, climate change, and the energy sector and geopolitics. (The impact of geopolitics on the future was a theme for Bank of Japan Governor Kazuo Ueda as well, who noted that “longer-run effects of geopolitical factors on the Japanese economy are unsurprisingly very uncertain.”<sup>2</sup>)

However, Lagarde identified some positive trends as well. In particular, she noted that the pandemic accelerated digitalization, which increased the ability to work remotely — and that should support a more flexible labor market and help increase labor force participation. She argued that the development of artificial intelligence (AI) should also help, while addressing fears that artificial intelligence and other technological innovations would cause significant job loss. She acknowledged concerning research that identified that more than a quarter of jobs in advanced economies are at risk of elimination because they rely on skills that could easily be “automated” with artificial intelligence. However, she pointed out ECB research which finds that employment in jobs more exposed to AI have risen in most European countries over the past decade, rebutting the idea that the AI revolution will necessarily lead to a decline in employment.

(For more on AI, listen to Invesco’s recent podcast on the topic with my colleagues Brian Levitt and Ashley Oerth.)

Lagarde also focused on three key tenets for monetary policymaking going forward: clarity, flexibility, and humility. Her emphasis on humility, especially when it comes to forecasting, was particularly appropriate, from my perspective, and synced with the Bank of England’s efforts to improve its forecasting. She explained, “We cannot make policy based on simple rules or intermediate targets in an uncertain economy...And this means that we cannot exclusively rely on models that are estimated with old data, attempting to fine-tune policy around point forecasts. At the same time, we must also avoid the other pitfall of focusing too much on current data and ‘driving in the rearview mirror,’ since this is likely to make monetary policy a reactive force rather than a stabilizing one.”<sup>3</sup>

I found it powerful that she pointed to research indicating that households trust central bank forecasts less if their recent forecasts have been poor. She offered up two potential solutions: talking about forecasts in a more contingent way and providing better explanations for errors. She underscored that ECB staff have started publishing the main factors behind any ECB inflation forecast errors — and will continue to do so.

One key takeaway from the conference falls under the theme “High Anxiety” (which is an under-appreciated Mel Brooks movie from the 1970s). A number of speakers worried that some structural changes, such as trade barriers and industrial policy-driven changes to supply chains, could result in an environment of higher inflation, which could in turn lead to higher rates for longer. Lagarde said that “the new environment sets the stage for larger relative price shocks than we saw before the pandemic.” Bank of England Deputy Governor Ben Broadbent discussed causes of the high level of inflation in the UK, and worried specifically about wage growth going forward. He concluded that monetary policy “may well have to remain in restrictive territory”<sup>4</sup> for some time to come. In other words, higher for longer.

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### **“Red carpet” interviews reveal hints of what may come**

No red carpet awards show would be complete without a bevy of sideline interviews, and the same holds true for Jackson Hole. One interview in particular caught my attention: Cleveland Fed President Loretta Mester shared that “I have a base case of soft landing...”<sup>5</sup>, which seems to support the view that under-tightening by the Fed would be worse than over-tightening. I think that’s a mistake; this is definitely not “La Dolce Vita.” In my view, there’s increasing evidence that the US could be in for a bumpy landing rather than a soft one.

Among that evidence: S&P Global released its flash US Purchasing Managers’ Index (PMI) for August last week, showing that US Manufacturing PMI has fallen further into contraction territory at 47 versus 49 in July.<sup>6</sup> More concerning was US Services PMI. While still in expansion territory at 50.4, August’s data is well below the July reading of 52.3 and is at a six-month low, with new orders falling for the first time since February.<sup>6</sup>

I think over-tightening is a greater risk for the Fed than under-tightening at this point, especially given so much uncertainty. In fact, last week we were reminded of that future unpredictability in an earnings report from Macy’s: “In light of ongoing macroeconomic pressures and uncertainty on when those will abate, the company continues to take a cautious approach on the consumer...”<sup>7</sup>

This is not a US-specific problem. Other developed economies are experiencing similar issues. Early PMI survey data for August from S&P Global showed the eurozone and UK experiencing falling business activity. However, this is in contrast to impressive flash PMI readings for Japan, with services PMI at a very robust 54.3.<sup>8</sup> This is a reminder of the negative impact of tighter monetary policy among Western developed economies — and of its lagged effects. Hopefully it encourages central bankers to “Do the Right Thing” and end their respective rate hike cycles.

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### **In other news: Chinese stocks get a boost from stamp duty announcement**

I would be remiss if I didn’t mention the important announcement that came out of China last week — that it would be lowering the stamp duty, which is a tax on securities transactions. Stocks in China and Hong Kong reacted positively to the news, and that’s not surprising. On the rare occasions when this has happened in past decades, it has resulted in a nice pop in stock prices. As I said before, because of the negative sentiment around Chinese equities, any policy support could have a positive impact on stock prices. I hope this will be the “Inception” of other policy moves to support the Chinese economy and markets.

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**Notes**

<sup>1</sup>Source: Federal Reserve, transcript of Jay Powell speech, Aug. 25, 2023

<sup>2</sup>Source: Reuters, “BOJ Ueda says China’s slowdown adds to economic uncertainty,” Aug. 28, 2023

<sup>3</sup>Source: European Central Bank, transcript of Christine Lagarde speech, Aug. 25, 2023

<sup>4</sup>Source: Bank of England, transcript of Ben Broadbent speech, Aug. 26, 2023

<sup>5</sup>Source: FXStreet, “Fed’s Mester: Undertightening would be worse than overtightening,” Aug. 25, 2023

<sup>6</sup>Source: S&P Global as of Aug. 23, 2023. Purchasing Managers’ Indexes are measured from 0 to 100. A reading higher than 50 indicates economic expansion. Below that indicates contraction.

<sup>7</sup>Source: Macy’s second-quarter results press release, Aug. 22, 2023

<sup>8</sup>Source: S&P Global, Aug. 23, 2023

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**Important information**

Past performance is not a guarantee of future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China’s dependency on the economies of other Asian countries, many of which are developing countries.

Purchasing Managers’ Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

Tightening monetary policy includes actions by a central bank to curb inflation.

The opinions referenced above are those of the author as of August 28, 2023. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.