FEDERAL RESERVE POLICY: A NEW DIRECTION

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The Fed's new approach to setting policy rates reflects a change in perception regarding the relationship between inflation and unemployment. It is also a reflection of its heightened fears of both deflation and a prolonged period of elevated unemployment. The Fed is willing to accept a higher rate of inflation as a solution for what it perceives as monumental risks to the real economy resulting from the COVID-19 pandemic. The most significant ramifications are upward pressures on bond yields in the medium term; common stocks, commodities, precious metals, and real estate should be the main beneficiaries.

Summary and Major Conclusions:

- In the most significant revamp of monetary policy in many years, Federal Reserve Chairman Jerome Powell announced that the Fed is embracing a radical new approach to setting short-term interest rates.

- As opposed to raising rates pre-emptively in anticipation of higher inflation, the Fed will adopt a more patient and less forward-looking approach when deciding to raise policy rates.

- In addition, the Fed is adopting a more flexible and eclectic approach to setting interest rates, taking into account a broader range of factors. This approach is opposed to the mechanical rules-based policy of previous years that centered on trends in inflation and unemployment.

- The definition of the official 2% inflation target has also changed. Instead of using a point-in-time inflation target of 2% as a trigger for raising interest rates, the FOMC will target an average inflation rate of 2% over time.

- In the current environment, this means that the FOMC will tolerate an interim period of inflation exceeding 2% in order to compensate for the period of sub-two-percent inflation in recent years. Core consumer inflation averaged 1.65% during the five years ending in 2014, exceeding the 2% target only on several rare occasions.

- There are several explanations for the Fed's shift in its policy framework. Research by the Fed has brought about a change in its view regarding the relationships among inflation, unemployment, interest rates, and economic growth.

- Since the 1960s, economists have held the view of a stable and inverse relationship or trade-off between inflation and unemployment. However, evidence in recent years has contradicted this textbook economic theory held by Keynesian economists.

- The evidence of recent years strongly suggests that there is no trade-off between inflation and the unemployment rate. The Fed now believes that inflation can remain under firm control at lower rates of unemployment than previously believed.

- Specifically, the unemployment rate declined over the decade of the 2010s, from a peak of 10% in 2009 to 3.5% in 2019. During this ten-year period, consumer inflation also declined from a peak of 2.1% in 2012 to a low of 1.6% in 2019.

- The new direction of policy reflects the Fed's profound economic fears. It appears that the Fed is more than willing to accept the risk of higher inflation because of its far greater fear of losing control of the economy on the downside.

- Federal Reserve officials are also aware of the power of its guidance and rhetoric to influence and the economy. Powell believes that he can bring about an increase in economic confidence and risk-taking with public statements "promising" that the FOMC will not raise policy rates for the next three or four years.

- The most significant implications are for financial markets. Unlike the uncertainty regarding the relationship between monetary policy and the economy, the relationship between Fed policy and financial markets is compelling.

- The Fed's new policy framework should trigger a rise in long-term interest rates in the medium term and a steepening in the Treasury yield curve. This radical policy development is unequivocally bearish for the government bond market.

- Rising inflationary expectations and a steepening yield curve are also consistent with increased investor flows into risk assets such as common stocks along with tangible assets such as industrial commodities, precious metals, farmland, and real estate.

- Whereas virtually all equity markets should benefit from the structural change in Federal Reserve policy, economically sensitive stocks should benefit most, creating tailwinds for value stock groups.

- Current weakness in the US dollar should intensify in coming years, along with a rising fear of US inflation. Dollar weakness is also consistent with investor expectations of a decline in real short-term rates in the US.

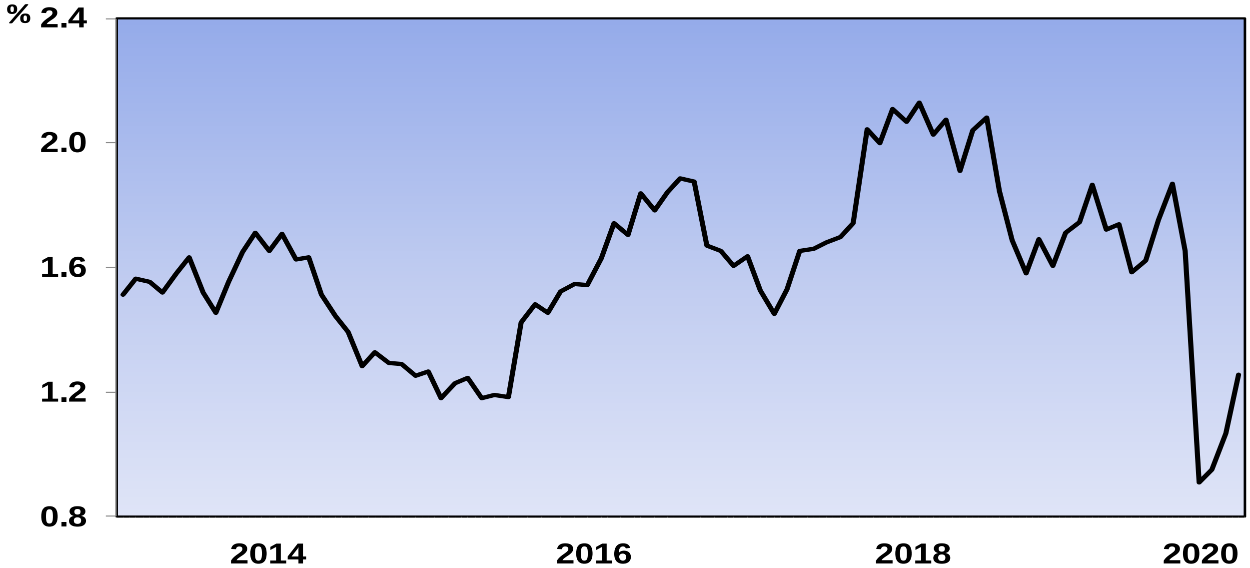
"The persistent undershoot of inflation from our 2 percent longer-run objective is a cause for concern. Many might find it counterintuitive that the Fed would want to push inflation higher. After all, low and stable inflation is essential for a well-functioning economy. However, inflation that runs below its desired level can lead to an unwelcome fall in longer-term inflation expectations, which in turn, can pull actual inflation even lower, resulting in an adverse cycle of ever-lower inflation and inflation expectations.

In seeking to achieve inflation that averages 2 percent over time, we are not tying ourselves to a particular mathematical formula that defines the average. Thus, our approach could be viewed as a flexible form of average inflation targeting. Our decisions about appropriate monetary policy will continue to reflect a broad array of considerations and will not be dictated by any formula."

Jerome H. Powell, Chairman
Federal Reserve Board
August 27, 2020

Federal Reserve Chairman Jerome Powell announced that the Fed has adopted a radical new approach to managing monetary policy. In the most significant revamp in years of the Fed's policy framework for setting interest rates, Powell explained why a new mindset was both necessary and appropriate. This week's *Economic Perspective* provides answers to questions regarding the shift in Federal Reserve methodology and implications for the economy and financial markets.

Chart 1: Consumer Inflation Under Excellent Control for Many Years
The GDP Consumer Price Deflator, Annual (%) Change
Source: Bureau of Economic Analysis



COULD YOU DESCRIBE THE CHANGE IN APPROACH ADOPTED BY THE FEDERAL RESERVE IN THE MANAGEMENT OF MONETARY POLICY?

Chairman Powell announced a new framework for managing monetary policy. In essence, this new strategy involves three fundamental changes in the Fed's approach to setting short-term interest rates:

1. As opposed to raising rates ***pre-emptively*** in anticipation of higher inflation — as has been the convention for decades — the Fed will adopt a more patient and less forward-looking approach when deciding to raise policy rates.

2. Instead of a ***mechanical rules-based policy*** centered on the unemployment rate and inflation, the Federal Open Market Committee (FOMC) is adopting a more flexible and eclectic approach to setting interest rates, taking into account a broader range of factors.

3. The definition of the official 2% inflation target has changed. Instead of using a ***point-in-time inflation target of 2%*** as a guide to raising interest rates, the FOMC will target an ***average inflation rate of 2% over time***.

In the current environment, this means that the FOMC will tolerate a period of inflation in excess of 2% in order to compensate for the period of sub-two-percent inflation in recent years. Core consumer inflation averaged 1.65% during the five years ending in 2014, exceeding the 2% target infrequently during 2012 and 2019 (see chart 1).

WHAT IS THE PRACTICAL SIGNIFICANCE OF THIS SHIFT IN APPROACH?

As a generalization, management of monetary policy will become more flexible and less formula-based. Instead of lifting rates in anticipation of higher inflation, the FOMC will likely show greater patience and tolerance of the risk of rising inflation.

Similarly, the Fed is dropping its longstanding mandate to raise its policy rate when the annualized rate of inflation reaches 2%. Instead, the FOMC will be targeting an ***average*** 2% inflation rate in future years. Consequently, it seems reasonable to assume that the actual rate of inflation over the next five years will average somewhat higher than the 1.65% rate of the past five years, perhaps even exceeding its 2% average target.

The underlying message is that the FOMC has become less fearful of inflation, and will exhibit a greater willingness to tolerate a higher rate of inflation. ***The practical implication is that this new policy framework will effectively raise the potential for higher inflation over time***.

WHAT PROMPTED THE FED TO MAKE THIS CHANGE?

There are several explanations for the Fed's shift in its policy framework. Research by the Fed has resulted in a change in its view regarding the fundamental relationships between inflation, unemployment, interest rates, and economic growth. Of greatest importance is its view regarding the relationship between unemployment and inflation. The Fed has also lost confidence in the capacity of fiscal policy to support the economy when needed. Finally, the Fed wants to avert a deflationary trap as has occurred in Japan over the past thirty years and the eurozone since 2012.

COULD YOU ELABORATE ON THIS CHANGE IN THE FED'S PERSPECTIVE?

Since the 1960s, economists have held the view that there existed a stable and inverse relationship or trade-off between inflation and unemployment. This theory — referred to as the Phillips Curve — claims that inflation is higher when unemployment is low, and vice versa. However, data from recent years have totally contradicted this economic theory held by Keynesian economists (see chart 2).

COULD YOU REVIEW THE STATISTICAL EVIDENCE FROM RECENT YEARS?

The unemployment rate declined steadily during the past decade, from a peak of 10% in 2010 to a 50-year low of 3.5% in 2019. During this ten-year period, the core consumer inflation rate *fell* from a peak of 2.1% in 2012 to a low of 1.6% in 2019. *In short, the historical data strongly suggests that there is no trade-off between inflation and the unemployment rate*.

Chart 2: No Historical Evidence of a Trade-Off Between Inflation and Unemployment
US Unemployment Rate ------------
US Consumer Inflation -------------
Source: Bloomberg

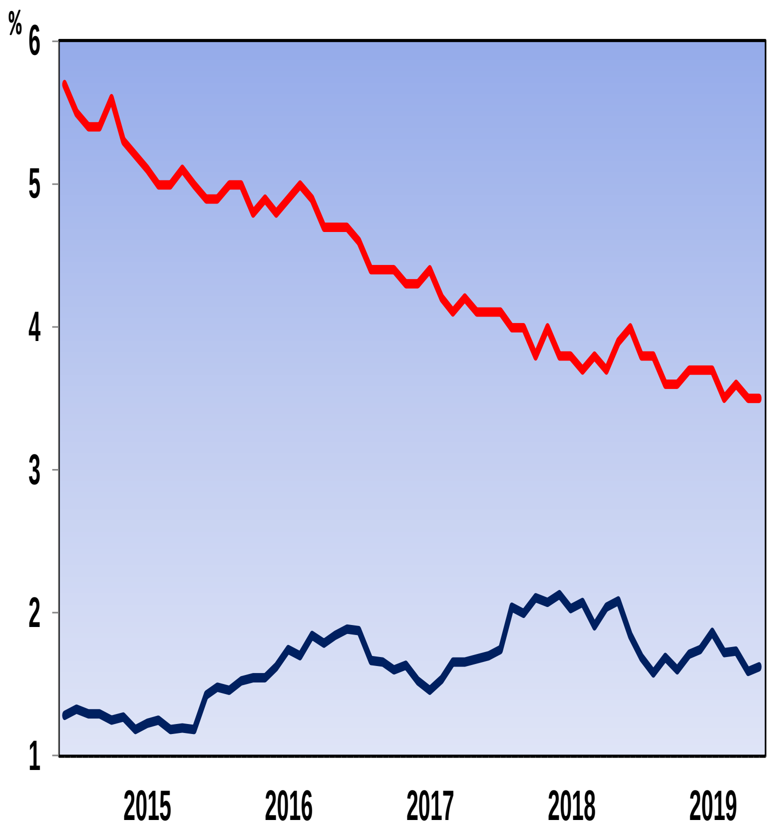
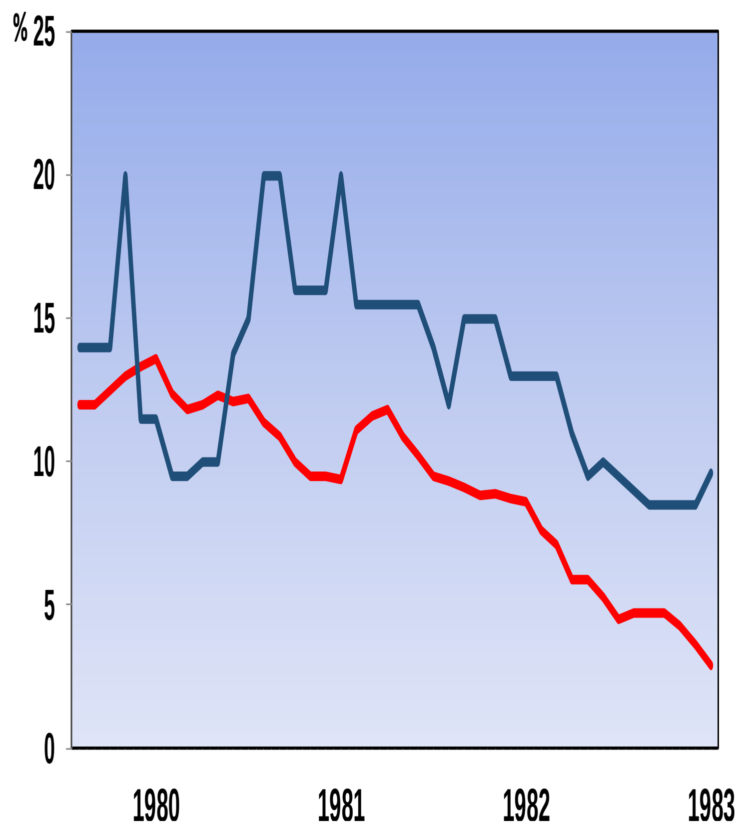


Chart 3: Fed Raised Real Policy Rates to an All-Time High in the 1980's to Crush Inflation
Federal Funds Target Rate ------------
Core Consumer Price Inflation ------------
Source: Bloomberg



Based upon these historical trends, the Fed has concluded that the relationship between unemployment and inflation has undergone a structural change, and that the Phillips Curve is no longer valid. _In other words, the Fed now believes that inflation can remain under firm control at lower rates of unemployment than previously believed_.

IS THIS SUDDEN SHIFT IN MONETARY POLICY UNPRECEDENTED?

It is actually reminiscent of the Federal Reserve **declaration of war on inflation** in the late 1970s and early 1980 — only in reverse. As the rate of inflation accelerated toward 14% in 1980, the Federal Reserve — under newly appointed chairman Paul Volcker — initiated an attack on inflation, ***doubling its policy rate from 10% to 20% in less than six months.***

The inflation-adjusted (real) federal funds rate reached an unprecedented **8%** at the end of 1980, as the ferocious tightening in monetary policy triggered the worst recession since the second world war. Core consumer inflation plunged from a record 13% in 1980 to less than 5% in 1982. _The current episode is a mirror image of this earlier period_ (see chart 3).

WILL THIS NOVEL APPROACH INCREASE THE RISK OF FUTURE INFLATION?

Yes, but I believe that the Fed is more than willing to accept the risk of higher inflation because of its far greater fear of losing control of the economy on the downside. Stated differently, *the Fed's greatest fear is a prolonged period of high unemployment and deflation, whereas its fear of an overheating economy is relatively small*.

Federal Reserve officials are also aware of the power of its guidance and rhetoric to influence financial markets and the economy. Specifically, Powell believes that he can eventually bring about an increase in economic confidence and risk-taking with a "promise" that the FOMC will not raise policy rates for the next three or four years.

WHAT ARE THE ECONOMIC IMPLICATIONS OF THIS SHIFT IN THE FED'S POLICY FRAMEWORK?

The primary economic implication is the ***potential*** for higher inflation in future years. The implications for company profit margins are also positive. History reveals that a rising trend in selling prices tends to precede a rising trend in wages, allowing for a period of widening profit margins.

The implications for economic growth are unclear. Classic economic theory postulates that a period of monetary stimulus should ultimately lead to faster economic growth, to a greater or lesser extent. However, the experience of the past two decades contradicts this theory: Ultra-accommodative monetary policy failed to generate above-average growth in aggregate spending and output. Since 2000, US real GDP expanded at a pedestrian compound annual rate of only 2%.

HAVE YOU CHANGED YOUR FORECAST FOR INFLATION?

Not in the medium term. The abundance of economic slack will almost certainly keep inflationary pressures in check in 2021 and 2022. Moreover, inflation is a classic lagging indicator, and can lag policy changes by two years. However, beyond 2022, the risk of higher inflation could increase considerably. Annual growth in the broad M2 money supply since earlier this year has been unprecedented (see chart 4).

WHAT ARE THE PRIMARY IMPLICATIONS FOR FINANCIAL MARKETS?

In principle, changes in monetary policy are manifested in financial markets well in advance of changes in the real economy. The Fed's new policy framework should trigger a rise in long-term interest rates and a steepening in the Treasury yield curve. *Market expectations of faster inflation and a potential upward trend in long-term interest rates are almost always manifested in a steepening yield curve* — just as expectations of lower inflation is consistent with a flattening yield curve. In short, this policy development is extremely bearish for the government bond market in coming years (see chart 5).

Chart 4: Unprecedented Growth in the US Money Supply
M2 Money Supply, % Annual Change
Source: Federal Reserve

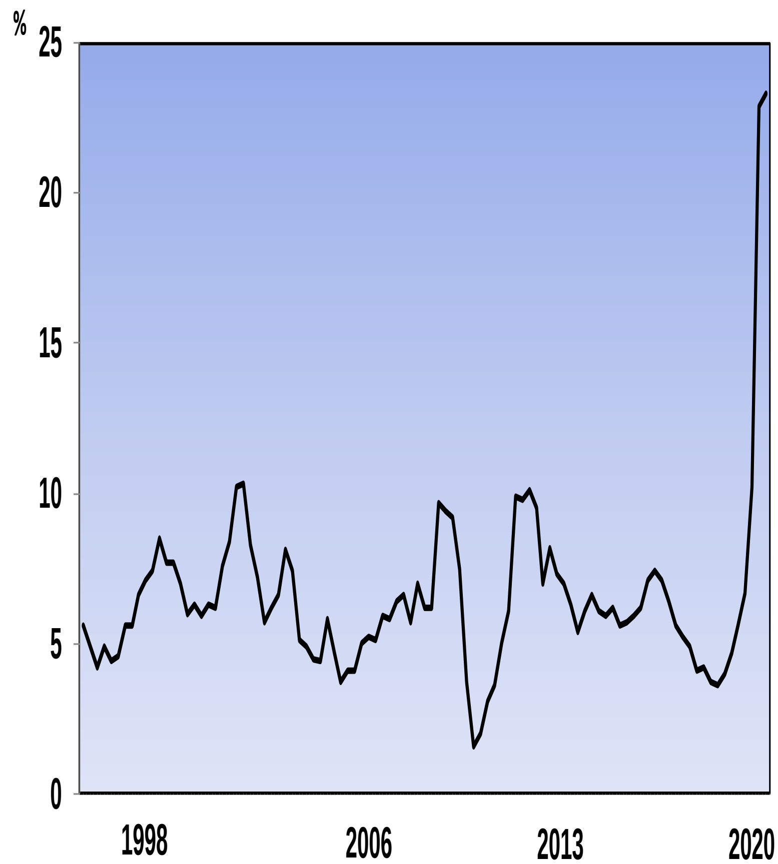


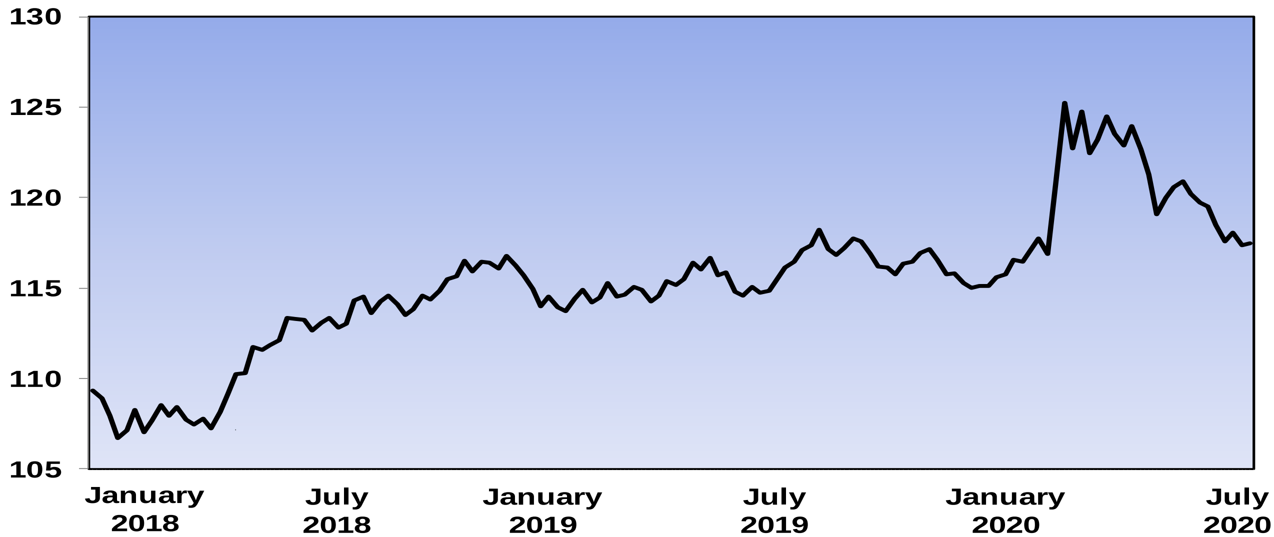
Chart 5: A Steady Rise in Inflation Expectations
Break-Even Inflation (%) Rate
Treasury Inflation-Protected Securities (TIPS)
Source: Federal Reserve

ARE THERE OTHER INVESTMENT IMPLICATIONS?

Rising inflationary expectations and a steepening yield curve are classic ***pro-growth*** indicators and consistent with increased investor flows into risk assets such as common stocks along with tangible assets such as industrial commodities, precious metals, farmland, and real estate. Whereas virtually all equity markets should benefit from the structural shift in Federal Reserve policy, economically sensitive stocks should benefit most, creating a tailwind for value stock groups.

Excessive monetary ease — and a policy bias toward higher inflation — is also consistent with a weakening currency. The US dollar is already in a bear market, which should intensify in coming years as global investors increasingly fear higher US inflation. Fiscal and monetary policy in the US are far and away the most expansionary within the global economy. Dollar weakness is also consistent with investor perceptions of a relative decline in *real short-term rates* in the US. Increased flows into non-dollar assets should benefit international stocks
(see chart 6).

Chart 6: Bull Market in US Dollar Appears to Have Ended
US Trade-Weighted Dollar Index
Source: Federal Reserve



COULD YOU SUMMARIZE THE MAJOR POINTS?

The Fed's novel approach to setting policy rates reflects a change in perception regarding the relationship between inflation and unemployment. It is also a reflection of heightened fears of deflation and the potential for a permanently elevated rate of unemployment. The Fed is willing to accept a higher rate of inflation as a possible solution for what it perceives as monumental risks to the real economy resulting from the COVID-19 pandemic.

The most significant ramifications are upward pressure on bond yields and a steepening yield curve. Pro-growth assets such as common stocks and classic inflation hedges such as commodities, precious metals, and real estate should be the primary beneficiaries, while the current bear market in the US dollar should intensify.

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