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The Fed's Next Move

Deconstructing "lower for longer" in the wake of the U.S. Federal Reserve's new monetary framework

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The U.S. Federal Reserve (Fed) walks a fine line between clearly communicating its intentions to avoid alarming the capital markets and giving itself enough latitude in its stimulus war chest. By all accounts, the U.S. central bank is succeeding. However, between Federal Reserve Chairman Jerome Powell's August speech at the Jackson Hole Economic Symposium that unveiled a new inflation framework and the September 15-16 Federal Open Market Committee (FOMC) meeting, there is no shortage of information for markets to digest.

To help fill in the blanks, I sat down with former Fed Chair Dr. Janet Yellen on September 17, to get the perspective of someone who used to be in the driver's seat at the world's most influential central bank. In a wide-ranging conversation, Dr. Yellen expressed her support for the new framework, which will allow inflation to rise above 2% for a period of time. She also suggested that the Fed will likely continue to step in and offer future liquidity, but that the Fed's interventions ultimately cannot happen in a vacuum. As my colleagues and I have also underscored at Principal, monetary policy is most effective when countered by a well-coordinated fiscal policy effort.

Inflation? What inflation? Deciphering the new FOMC inflation framework

For the past 10 years, the U.S. has been using tools such as policy rates and Quantitative Easing to stimulate the economy. Even with these efforts, it struggled to kick-start inflation and bring it up to its optimal target of 2%. After the government effectively froze business activity to slow the advance of COVID-19, the Fed now faces a more daunting task of reheating the economy amidst one of the worst social and health crises in history.

The new inflation framework unveiled by Chairman Powell at Jackson Hole in August is the latest policy attempt to achieve that elusive goal. The new framework – a significant paradigm shift – will allow inflation to tick above 2% "for some time" before tightening – exactly how much higher and for how long is unknown. While the reaction to the new framework has been mixed, in my conversation with Dr. Yellen, she expressed more confidence in the new approach than I expected. She calls it a subtle but important change that's intended to consciously push up inflation rates, giving the Fed more latitude to deal with a crisis.

Ultimately, the new approach is a make-up strategy to help fill in the gaps so that longer-run inflation stays anchored at or slightly above the Fed's desired 2% cruising altitude. In a way, it's also a recognition that the Fed has few remaining levers to pull to manage the current crisis and it needs to start readying the foundation now to ensure it has the power to act in the future.

How much ammunition does the Fed have left?

While the Fed may not have unlimited ammunition to deal with a crisis, it doesn't mean the central bank isn't willing to get creative to find a solution. That begs the question: Could the Fed use negative rates to stimulate the economy, following Japan's path and recent talk by the Bank of England that it could allow rates to fall below zero? Although Dr. Yellen wouldn't rule negative rates out, she doesn't see this tactic being used in the U.S. It seems that while central bankers are willing to try new things, especially in the wake of calamity, they really don't like the prospect of negative rates.

Negative rates would present a host of other challenges that could be detrimental to the economy while having a minimal positive impact. They could have a harmful effect on bank profitability, and European evidence suggest they have not stimulated bank lending. Furthermore, money market funds would struggle to operate in that environment, which could create problems in the short-term funding market. The slashing of rates has already distorted financial markets, with potential serious implications for pension systems worldwide.

As Dr. Yellen pointed out in our conversation, the policy shift introduced by Chairman Powell is about maximizing the space it has to conduct monetary policy. But monetary policy, on its own, won't be enough to deal with the current challenges. Forward guidance, corporate bond purchases - even negative interest rates in the worst-case scenario - are all on the table. But it's clear they are not going to be enough if there is another crisis.

Cue fiscal policy. At this juncture, despite the Fed having pulled out almost all its stops, there is a very strong need for fiscal policy to play a greater role in stimulating the economy. Market participants can expect some degree of volatility as Congress works through its impasse over the next fiscal stimulus package – a decision that won't be made easier by the upcoming U.S. election.

Fiscal policy needs to step up

The power of fiscal policy was demonstrated earlier this year with the CARES Act, which added about $600 a week to unemployment compensation and provided outright grants to small businesses to help them survive. When you have an economy that's deeply depressed, low-interest rates alone will not provide enough stimulus to get inflation to 2%, let alone overshoot it. Fiscal policy needs to work in conjunction with monetary policy to get the economy back to full employment.

Of course, fiscal policy comes with its own set of risk, including crowding out investment and consumer spending. The long-term effects of fiscal stimulus measures also cannot be overstated.

The combination of the downturn and the fiscal support is likely to raise the debt-to-GDP ratio in the United States from about 80% pre-crisis to approximately 100% at the end of 2020 and then approximately 110% by the end of 2023. But the rising debt-to-GDP ratio alone isn't as worrying as the fact that it's unlikely to plateau. The aging population means that costs of Medicare, Social Security and Medicaid will only continue to rise. Indeed, as Dr Yellen pointed out, the demographics and their implications have been evident for 30 years, yet the government has not been taking in sufficient tax revenue to deal with this ticking fiscal timebomb.

Getting the markets off their dependence on low rates and stimulus programs will be a tricky process, but not an impossible task. Dr Yellen, drawing from her own experience, noted that when the time comes, the Fed will need to go to great lengths to communicate this change to markets well in advance, setting out a clear vision for interest rates and what would need to happen to unwind this massive stimulus.

In the meantime, even though policy statements are still short of specifics, no one can misconstrue the Federal Reserve's plan. It will be years, not months, before this paint dries.

What does this mean for capital markets, and investors?

Frankly, it is hard to envision an environment of positive inflation after the massive event-driven shocks sustained by the economy. Dr. Yellen reinforced for us that the end game for the Fed is unemployment drifting lower in an economy that is allowed to run hotter for longer. They have few additional levers to pull, yet at least it's clear the Fed is committed to considering every option to stimulate the economy.

We believe that the Fed is willing to increase asset purchases or reach even further into a dwindling war chest to make this happen. That suggests that investors can expect a steeper yield curve over time. With that, inflation break-evens should start to pick up, which would be beneficial for real assets.

With a steeper yield curve accompanied by an environment of low-growth and positive, steady inflation, market participants can expect to see certain sectors rotate to the fore. Based on our analysis, equities and real assets, including Treasury Inflation-Protected Securities (TIPs) and real estate will likely be beneficiaries. To be clear, we are not looking at an environment of runaway inflation, but inflation of a healthier variety.

Government bonds and traditional fixed income will continue to be a safe harbor and play the role of portfolio diversifier; however, investors can expect yields to remain at depressed levels for the foreseeable future. Investors will look further afield for yield and inevitably reach down the risk spectrum in its pursuit. However, in credit markets, fundamental analysis and quality will be essential. Here, ample liquidity shouldn't be mistaken with credit quality. Preferred securities will also likely be winners due to the inflation protection potential of their income stream and attractive yield.

Overall, the backdrop continues to be very supportive of equities. Tech and mega cap should continue to fare well in an environment where short-term bond yields continue to be pinned down. The ascent of technology as a secular force has only been accelerated by COVID-19. As the recovery continues to gain traction, we can expect a rotation into other sectors outside of the mega caps that have dominated this initial tranche of the comeback. Over the long term, as the pendulum swings away from momentum and defensive stocks, and as the yield curve steepens, investors may even see a rotation back into value.

In this environment, it's more important than ever to focus on owning good-quality companies. Given a bull run fueled by relatively narrow leadership that accounts for a large part of the index, it's easy to forget that not all securities are equal in quality. With easy access to cheap money propping up weaker players, there will be winners and losers in the period ahead. It's important to be discerning when investors may not be able to count on a rising tide to lift all boats. Therefore active management will become increasingly important. Without a straight-line recovery, investors have to be selective to hold companies that will be more resilient against the headwinds that lie ahead.

As the Fed chair who led the charge on raising short rates after seven years of the policy rate at zero, Dr. Yellen's message couldn't come at a more opportune time: The Fed is intent on supporting rather than surprising markets. Overall, our session with Dr. Yellen hasn't altered our views, but it has certainly sharpened our perspective. Markets have become dependent on ultra-low rates, such that unwinding current levels of stimulus will be a challenge. It is clear that round one of the narrative will involve actively addressing the recovery at hand. Round two will involve dealing with the inevitable hangover of policy, debt levels and dependency on low rates.

While capital markets continue to be optimistic as we emerge from the pandemic, it is likely the road ahead will be punctuated with periods of uncertainty, volatility and potential growth unraveling. Monetary policymakers have given the markets a substantial backstop, but the heavy lifting is still to be done.

Risk considerations

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