Market and Economic Insights

Strategy Spotlight

If inflation won't change, perhaps the Fed will

In November 2018, the Federal Reserve (Fed) announced a review of the strategies, tools and communication practices used to pursue its mandate of maximum employment and price stability. Policymakers plan to report their findings to the public during the first half of 2020, though implementation of any new framework would probably not occur until 2021. The most likely change is the adoption of a) temporary price-level targeting or b) average inflation targeting. Under a temporary price-level target, the Fed would commit in advance to holding off on rate hikes at least until any inflation shortfalls experienced during the zero-lower-bound period had been fully offset. Under average inflation targeting, the Fed would aim to achieve above-target inflation in "good" times to offset below-target inflation experienced during "bad" times, so that longer-run average inflation and inflation expectations are in line with target. The implications of such policies would depend on their details (such as the proposed length of the Fed's "lookback" period) and overall credibility, but the change would likely be supportive for equities, positive for Treasurys (with a steeper yield curve) and negative for the U.S. dollar.

Inflation targeting as we know it: How did we get here?

In the 1970s and 1980s, inflation was high and variable, creating uncertainty around expectations, which in turn created higher and more variable inflation. The Fed implemented inflation targeting in the 1990s in an effort to bring down inflation expectations and create stable, well-anchored expectations going forward.

This policy worked extremely well prior to the Great Recession. Central banks were able to achieve stable and low inflation, which increased policymakers' credibility and reined in expectations. Many central bankers took a victory lap and proclaimed the period "The Great Moderation."

Why pivot now?

The problem that central banks need to solve today arises from the breakdown of a traditional economic equation. With economies such as the U.S. operating near full potential and unemployment rates remaining low, inflation should push higher. This hasn't happened with any consistency. In the meantime, central bank credibility has eroded due a seemingly endless string of quarterly inflation shortfalls. Moreover, the Fed's expectations for the long-run (real) neutral interest rate have continued to decline and now hover around 1%.

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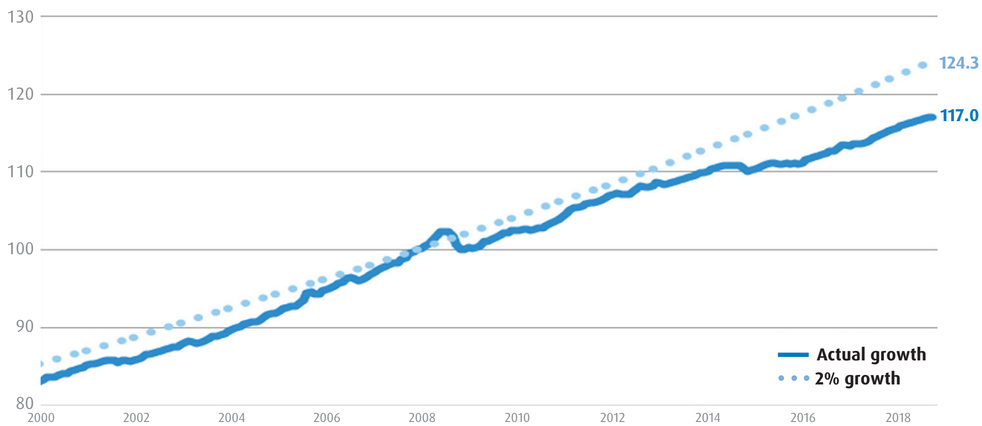
A low neutral rate limits the Fed's ability to cut the federal funds rate and increases the frequency and duration of periods when the policy rate is constrained by the zero lower bound (ZLB). Research by the Fed[1] suggests that the ZLB could come into play as much as 40% of the time in the future. This possibility raises the question of whether or not the current framework provides the Fed with adequate tools to deal with today's economic environment.

The following chart shows the divergence between actual price level growth and the Fed's 2% target.

Price level growth versus Fed expectations



January 2008=100.
Source: Federal Reserve Bank of St. Louis.

While the Fed has publicly downplayed significant changes to its framework and Chairman Powell has spoken of "evolution, not revolution," we think a change to the framework is more likely than not.

Give me the odds: How likely is the Fed to adopt a new framework?

By many accounts, the Fed is leaning toward adopting an average inflation targeting approach. That the Fed has framed the discussion the way that it has (by steadily noting that the current approach does not seem to work as well as it has in the past) would suggest as much. While the Fed has publicly downplayed significant changes to its framework and Chairman Powell has spoken of "evolution, not revolution," we think a change to the framework is more likely than not.

Despite the Fed's avowedly "non-political" status, some political considerations lurk in the background of this decision. These include the possibility that a framework change would be perceived as acceding to President Trump's call for lower interest rates and the potential backlash when inflation runs above target. Additionally, promoting financial stability is a key element of the Fed's dual mandate. The Fed could find itself wanting to raise rates to deal with financial instability rather than higher inflation, which could put it in a bind and lead to questions around the credibility of an average inflation targeting approach.

When would a framework change occur?

The Fed will sponsor a research conference in early June at the Federal Reserve Bank of Chicago, where ideas like average inflation targeting will be discussed with speakers and panelists from outside the central bank. The Federal Open Market Committee (FOMC) will conduct its own assessment of its monetary policy framework beginning around the middle of this year. They will likely share their conclusions with the public in the first half of 2020. If changes are to be implemented, this would likely occur in 2021.

[1] Michael T. Kiley and John M. Roberts, "Monetary Policy in a Low Interest Rate World"

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What does it all mean?

Much depends on the perception of the Fed's credibility. If investors and the public do not understand or have confidence in the Fed's strategy, inflation expectations could become unanchored. Several studies have shown that this scenario could become self-fulfilling, with GDP growth and employment overshooting as well. While this is an important concern for the Fed over the medium to longer term, how would a framework change ripple through markets in the shorter term?

If the Fed were to implement an average inflation targeting policy, the implications would appear to be as follows (assuming economic conditions roughly the same as those of today):

- **Supportive of U.S. equities:** The economic cycle would likely be extended, slightly higher inflation would lead to higher multiples and markets would have more confidence in future discount rates.
- **Positive for Treasurys/steeper yield curve in the short term:** Any rate hikes would be slower if inflation and/or growth were to accelerate.
- **Bearish for the U.S. dollar:** Higher inflation and increased risk appetite.

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