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Market Update: 27th August 2020

A Time for Change for The Fed

Central bankers from around the world convene on the Jackson Hole symposium each year to discuss the current economic climate and to hear each other's views on the challenges they face. However, few would disagree that this year's meeting has a stronger-common focus. Amidst the significant policy responses to the global pandemic enacted by governments and central banks from around the world, the focal point will be on Jerome Powell, the Federal Reserve Chairman who is expected to discuss the US central bank's review of monetary policy. The meeting takes place on the 27th and 28th of this month.

Current mandate

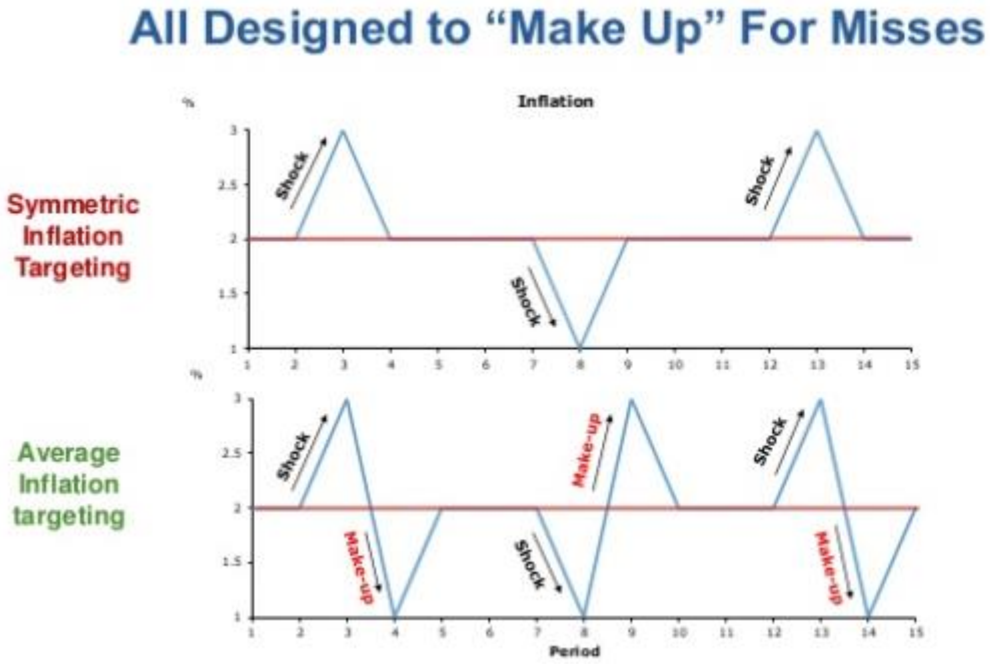
As a result of the 1970s stagflation episode in the US, the Fed established a dual mandate shortly afterwards in order to clarify the objectives of the Federal Open Market Committee (FOMC). The first mandate is to achieve maximum employment, meaning that all Americans who want to work are gainfully employed. The second mandate is to maintain stable prices, in order to allow individuals and businesses to make plans for the future and expect economic stability. This latter mandate is achieved through the Fed's control of monetary policy, using interest rates to adjust the inflation rate.

After the global recession, the Fed explicitly set a target of 2% inflation in 2012 to achieve its price objective. Despite their strenuous efforts over the last decade, the inflation rate has been persistently below its target, averaging at 1.5%. This has caused a problem for the Fed, coinciding with a time where the funds rate is stuck at the zero-lower bound and the unemployment rate is currently above 10%. Having missed its price objective for a number of years, the mandate has been under review, and financial markets will be observing closely as a new mandate could be put into place. Any changes would effectively alter the Fed's goal posts. At a time when most Fed policy makers see the funds rate remaining at the lower bound past 2022, it has become increasingly more likely an overhaul of the current mandate is required as the central bank adjusts its strategy to mitigate the pandemic.

Future mandate

In a press conference held earlier today, Fed Chair Jerome Powell confirmed the adoption of a new AIT, or average inflation targeting framework, which has been under consideration at the Fed for some time. Under this strategy, rather than the Fed attempting to hit a 2% inflation target every year, inflation expectations are anchored on, or close to, the target. Using component examples from the current environment, if inflation is below target and the funds rate was constrained at the ZLB, the Fed will try and make up for the undershooting inflation rate by allowing it to overshoot at another time. Importantly, for this framework to work, financial markets must believe that the Fed will keep rates lower than in standard inflation targeting, in order to push inflation above target in the near future. When this is utilised by the Fed, interest rates could be kept at the ZLB longer than the expected

2022 date. In this scenario, it will become cheaper and hence more viable for individuals and businesses to borrow and make financial choices, supporting an economic recovery.



Source: Federal Reserve Bank of San Francisco

Alternative measures, including forward guidance (FG) and negatives rates, are also likely to be discussed over the course of the meeting. At the June FOMC meeting, there was a growing consensus within the central bank that the Fed should "further clarify" its monetary policy intentions, which many expect as an explicit form of FG. FG is typically based on either an inflation or unemployment target and has been a tool used numerous times since the financial crisis. However, for this tool to be successful, the Fed needs to maintain credibility, otherwise market participants are unlikely to behave as desired on said guidance.

The market's reaction

The markets reaction to an AIT framework is dependent on the finer details – how far would the Fed allow the inflation overshoot and for how long, or an adjustment to the inflation rate which they anchor onto. However, the implementation of this framework should signal to the market that rates will be low for longer and this will not change even when inflation hits the 2% mark. In response to Thursday's meeting, we saw financial markets become more bullish as yields on longer-maturity bonds and US stocks rose along with gold prices. Moving forward, we also expect the implementation of this framework to have a dampening effect on USD. If the Fed is willing to support inflation overshoots, financial markets could see a continued weakening of the USD against other major currencies. When coupled with the already depressed outlook for the currency, capital outflows from the US will likely continue, and financial markets could see a supported reversal into continued non-US equity outperformance. Thursday's initial reaction resulted in a USD sell off, which we expect to continue in the short term amidst the expected volatility and slowing fundamental indicators.

Despite Powell not announcing any form of FG in this meeting, the expected volatility could force the Fed to consider issuing more detailed FG and more information on the possibility of negative rates in the next few months. If forward guidance is going to become a common tool, investors should receive a boost in confidence that the Fed will help guide and inform markets at regular intervals. In a period when volatility is high, removing some of the uncertainty will help support investment decision making and could result in a stronger than expected US recovery.

Our view

At a time when the S&P 500 is rallying, we are seeing fundamental economic indicators stalling in the US. Unemployment claims have been consistently around one million week on week and the expiration of US stimulus, without the replacement of a new policy package yet, could create a drag on the US economy in the short term. In light of the recent framework changes to how they target inflation, financial markets will take a sigh of relief that interest rates will remain low near the ZLB for several years and should not be tightened prematurely. The Fed also announced that it is adjusting its view of maximum employment, in order to allow the labour market gains to run more broadly. At a time when the US labour market is significantly depressed, financial markets will likely take refuge in the implied focus on strengthening the labour market, as the Fed has iterated the importance of the employment rates role in an economic recovery. The updated view appears to have put less emphasise on the concern that low unemployment can cause excess inflation.

The Fed seems to have made necessary updates to a framework which has not been working for some time. Not only will the new framework support the economic recovery, but it could also help the US achieve a more stable inflation rate as we progress through the economic cycle in the coming years. In the short term, we have taken profit on some of our exposure today, reducing our positioning in US equities, as the S&P 500 experiences all-time highs at a time when fundamental indicators are struggling, suggesting that the US market could be approaching a correction or a period of more muted returns. Alongside this, we expect a weaker USD in the short and medium term, which could lead to a non-US equity outperformance. We hold a positive outlook on the US economy in the medium term, however the recent US outperformance has encouraged us to look for opportunities which are less volatile in the short term yet provide a potentially stronger return as the global economy recovers.