Fed policy shift could lead to ‘communication error’

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KEY POINTS:

• Short-term interest rates likely to stay near zero indefinitely
• The Fed will base monetary policy decisions on average inflation, allowing inflation to move above the 2% target for an unspecified period of time

What should investors make of the Federal Reserve’s newly announced approach to its monetary policy framework? James Camp, CFA, of Eagle Asset Management, says it means an indefinite span of very low short-term interest rates as well as support for equity valuations, but that more details are needed.

Jerome Powell, Chairman of the U.S. Federal Reserve (Fed), announced the new approach on August 27. The Fed will allow inflation to overshoot its 2% target to compensate for prior periods of weaker inflation. Said differently, the 2% inflation target is now a long-term average rather than a set point target.

On the margin, this shift in policy framework should be accommodative for capital markets, says James Camp, Eagle’s Managing Director of Fixed Income and Strategic Income. “The Fed has memorialized what the markets already know: The Fed will be as accommodative as its monetary policy tools will allow given the historic deterioration in the real economy. Rates on the short-end will remain near or at zero indefinitely, providing more support for credit markets and higher equity valuations. With inflation expectations creeping up in recent weeks, we could start to see the yield curve steepen with long-term rates moving higher.”

The Fed also placed a greater focus on its full employment mandate, allowing employment to run at or above its maximum level as long as inflation does not drift too high. “The Fed has shifted focus from inflation to the labor market, and rightly so given the horrendous jobs data we’ve seen as a result of the current pandemic,” Camp says. “The Fed’s traditional tools like the Taylor Rule and the Phillips Curve have taken a backseat to a more flexible, human-based approach. While I believe these decisions are the correct ones for the health of the real economy, and I commend Powell and the Fed for their noble efforts, the Fed’s traditional toolkit cannot fix many of the problems in the labor market. How does the Fed plan to achieve these updated policy goals? That is what the market is going to want to know in the weeks and months ahead. The update to the policy framework, both in terms of inflation targeting and the labor market, was lacking in substance and follow through, frankly.”

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— James Camp, CFA

The Fed’s lack of guidance on these updated policies creates a higher chance of communication missteps going forward, says Camp. “The Fed has created a problem for itself by leaving too much room for interpretation. How long and how high does the Fed allow inflation to run above the 2% target? When push comes to shove, how will the Fed react when actually faced with inflation creeping from 2.1% to 2.2% or 2.3%?” he said. “The Fed has increased the chance of a communication error similar to how it handled the 2018 debacle when Powell placed interest rates increases on ‘auto-pilot.’ The Fed will need to be very clear in future meetings to maintain stability across asset classes.”

The next Federal Open Market Committee (FOMC) meeting is scheduled for September 16, 2020 where the Fed is expected to leave the target for the fed funds rate unchanged at 0%-0.25%.

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