28 August 2020

Investment Event

Fed goes lower-for-even-longer

US Federal Reserve (Fed) Chairman Jerome Powell announced changes to monetary policy strategy

The Fed will maintain its main goals of targeting 2% inflation and maximum employment

However, a shift to average inflation targeting and focus on closing employment shortfalls officially provides room for inflation to temporarily exceed target

Our views

A lower-for-even-longer Fed interest rate policy supports our strategic overweight stance on US equities

Meanwhile, the Fed's greater tolerance of higher inflation suggests a possible downside scenario to government bond prices

US Federal Reserve revises its monetary policy strategy

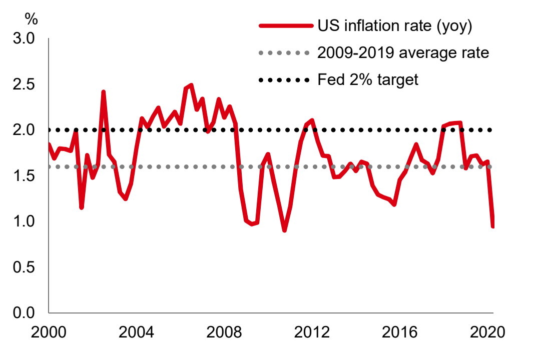
On 27 August, US Federal Reserve (Fed) Chairman Jerome Powell announced the main conclusions from the central bank's eagerly-awaited monetary policy review. Before Powell's speech at the Jackson Hole symposium, the Fed published a revised **Statement on the Longer-Run Goals and Monetary Policy Strategy** outlining formally the key changes.

The statement affirmed the Fed's dual-mandate to achieving an inflation rate of 2% in the long term and 'maximum employment'. In addition to this, as widely expected, the central bank formally adopted an average inflation targeting regime. This means that policymakers will allow inflation to go 'moderately above' its 2% target after periods of persistently low inflation. Meanwhile, on its employment objective, the central bank noted that "*shortfalls* of employment from its maximum level" rather than "*deviations*" will inform future policy decisions.

Lower-for-even-longer

The move towards using 'shortfalls' of employment to guide policy suggests that high unemployment is more a cause for concern for the central bank than low unemployment, unless the latter generates significantly above-target inflation.

Figure 1: US core PCE inflation*



*Personal Consumption Expenditures. Source: Bloomberg, 27.08.20

Meanwhile, the move to average inflation targeting follows an extended period of below-target inflation in the US. Between 2009 and 2019, the PCE core deflator – the Fed's preferred measure of inflation – has averaged 1.6%, 40bps below its long-term target (Figure 1). Overall, these measures imply that policy is likely to remain accommodative for a long time. This not only includes "lower-for-even-longer" interest rates, but also the possibility of an extended period of asset purchases. The market reaction was relatively muted, consistent with the switch to average inflation targeting being widely expected.

Investment implications

Average inflation targeting, by potentially lifting inflation expectations, is a step in the right direction for the Fed to sustainably achieve its inflation target. However, the success of the policy is far from guaranteed, especially if consumers do not believe the policy will actually achieve higher inflation, for example if unemployment is high and demand in the real economy is weak.

For the time being, underlying inflation trends remain very soft while in the aftermath of the Covid-19 shock demand remains below potential supply. This means fiscal policy support becomes critical in backing the recovery, and the Fed's announcement confirms their willingness to accommodate fiscal easing. In our baseline "swoosh-type" recovery scenario that sees the Fed on hold, robust, demand-side policy measures are likely to be needed while unemployment remains elevated.

Lower-for-even-longer interest rates also imply a low discount rate of future equity dividends, supporting current pricing. Overall, the Fed's policy stance is an important factor in our overweight strategic view on US equities.

Meanwhile, the Fed's tolerance of above-target inflation, with no detail on the degree of its tolerance, suggests some upside risks to US inflation in the longer term as the economy recovers. This suggests a possible downside scenario to government bond prices, where we maintain an underweight view. Nevertheless, we should also bear in mind that a longer period of asset purchases by the Fed can also provide support to global bond markets.

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