

Jackson Hole

The Fed's new stance on inflation

— By Jason Carvalho and Candice Bangsund



US Federal Reserve (the “Fed”) Chairman Powell used the Jackson Hole Symposium as a platform to introduce the new method by which the Fed will target inflation. The Fed is shifting its framework from an inflation target of 2% to a level of inflation “that averages 2 percent over time,” meaning that it will make up inflation rates that are below the 2% threshold by allowing inflation to rise slightly above target for a period of time. Interestingly, the Fed is not committing to any particular numerical formula to measure the outcome, (i.e. over what time period the average inflation will be based on), calling this “a flexible form of average inflation targeting.” It has therefore retained some flexibility in conducting policy and has not committed to specific targets that may or may not be achievable.

The framework shift acknowledges that the Fed has faced difficulties sustainably achieving the 2% inflation target over the past decade. The potential drawback of persistently undershooting the target is falling inflation expectations which ultimately result in lower yields because: 1) policy rates need to stay accommodative to influence inflation higher; and 2) lower inflation expectations result in lower yield compensation in holding longer term bonds.

Lower yields ultimately limit the amount the Fed can cut rates in the future to defend against recessionary periods, thus potentially limiting the effectiveness monetary policy tools.

The expectation of the new framework is to eventually push nominal interest rates up over time, when the economy can sustain

“...our new statement indicates that we will seek to achieve inflation that averages 2 percent over time. Therefore, following periods when inflation has been running below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.

— Chair Jerome H. Powell. August 27, 2020.

it, creating valuable policy room so monetary tools remain effective. Thus, the Fed’s announcement can be viewed as an expectation that policy is going to remain accommodative for an extended period of time. This should lower expectations for the path of policy rates, and effectively limit any upward shift in yields for longer term bonds, at least in the near term, as this would be counterproductive to the objectives of the Fed. Any signs that rates are rising to hindering

levels will likely be addressed to ensure the framework objectives can be achieved. With that being said, the bar for raising policy rates has moved higher, and we should expect lower rates for even longer. Eventually, we expect longer term rates to gradually move higher, as higher inflation expectations begin to be priced in by the market. Nevertheless, we would still expect them to remain relatively modest compared to where they stood a decade ago.

Impact on risk assets

This prominent shift in the Fed's monetary policy framework has extremely favourable implications for equity investors.

While it's undeniable that the environment of rock-bottom interest rates has driven multiples higher and acted as a crucial source of support for equity markets since the March lows, the good news is that this highly accommodative monetary policy stance is here to stay for an extended period of time and will be instrumental in guiding both the economy and stock markets higher over the next several years.

The obvious outcome of the Fed's more relaxed stance towards inflation is an environment whereby policymakers allow the economy to "run hot" in order to make up for a decade of below-target inflation. Indeed, the subsequent output gap and the abundance of spare capacity stemming from the economic stop in March and April have underpinned inflation and will allow the Federal Reserve to pursue these extremely stimulative monetary policies for the foreseeable future. This implies that interest rates will be pinned lower and for longer than historically would have been the case in order to close that gap, which will inevitably spark a stronger, more profound period of economic strength and corresponding upside in inflation expectations without the fear of premature policy tightening. The end result will be a new cycle of strong and above-trend growth that will follow for the next several years. In this reflationary environment, we'd expect the major equity indices to continue to make new highs. Commodities and other inflation-linked assets are also likely beneficiaries and investors should consider the Fed policy shift as a major tailwind for those asset classes over the coming 3-5 years at least.

Fixed income impacts

For fixed income portfolios, it will be important to ensure that managers have a diversified set of added value sources to generate returns in a low yield environment without taking on undue risk, and protect capital should longer term yields eventually migrate higher from their current levels. Notably, a disciplined framework and approach to managing the interest rate sensitivity (portfolio duration) and positioning along the yield curve to areas that are expected to be less impacted over the long-term, such as underweighting long-term bond yields. Additionally, in this more fragile economic environment, as investors search for yield to improve returns, high quality credit, such as provincial bonds and highly rated corporate bonds can be an effective tool to improve outcomes while limiting the potential for downgrades and undesirable portfolio volatility. Strong risk management is going to be paramount moving forward.

Alternatively, for investors that have a desire to remove interest rate exposure from portfolios, short duration bond strategies are a suitable option. They have lower volatility and less sensitivity to rising rates (though, as mentioned, we don't expect that to be a near term concern). The trade-off, however, is a lower overall yield in the portfolio.

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