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PGIM FIXED INCOME

FOMC Brings Back the Projections; Economy's Long Trek Back Boosts Treasuries

And Perspective on Where the ECB May Be Headed

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The Federal Reserve kept its current policy unchanged at today's meeting, leaving the target Fed funds range at 0.0%-0.25% and reiterating it will be kept at this level until the economy is well on track to fully recover. The Fed hammered home this point in its updated Summary of Economic Projections (SEP)—last released back in December 2019—showing FOMC participants now unanimously expect the Fed funds rate to remain unchanged at least through 2021 and a median projection that it will remain unchanged through 2022 as well. In response to a question about what the Fed will do if the resumption of economic activity proceeds much faster than expected, Chair Powell replied: "We are not even thinking about thinking about raising rates."

The Fed also provided additional guidance on the pace of its QE at today's meeting, noting it will continue purchasing Treasury and residential & commercial mortgage-backed securities "at least at the current pace." Meanwhile, the Fed continues to operate a myriad of credit and liquidity facilities set up this past spring, with a few programs, notably the Main Street Lending Facility for small and mid-sized firms, still to come. Powell reiterated the Fed intends to continue adapting the terms of these programs as needed to enhance their effectiveness. To date, though, these programs have gone a long way towards providing financing where needed and encouraging private sector lending to resume.

At his press conference, Powell noted monetary policy is in a good place right now. However, the FOMC also discussed two additional tools that could potentially be introduced in the future: explicit forms of forward rate guidance (which Powell noted has become a standard part of its toolkit at this point) and yield curve control (YCC), on which the FOMC received a briefing of historical experiences in using it. With an estimated 20-22 million people laid off during this pandemic and Fed projections showing it will likely take years for the economy to recover, Powell emphasized the Fed's goal is to be aggressively supportive to ensure there isn't lasting

The ECB's Latest Bold Action Represents a Clear Step-Change from the Past

The decision by the ECB last week to expand the Pandemic Emergency Purchase Programme by a further €600 billion helped reinforce its "no limits" policy launched in March. The latest decision brings total asset purchases under the PEPP to €1.35 trillion, or roughly 10% of euro area GDP—a similar order of magnitude of emergency easing seen in other major central banks, including in the U.S. and the UK. The ECB's latest actions represent a clear step change from the recent past, when policy action took the form of a laundry list of policy tweaks that in aggregate typically fell short of what was needed for the ECB to achieve its target. So, what accounts for this significant shift in approach?

A key reason, as emphasised by ECB President Lagarde in her recent press conference, is the low inflation outlook. Latest ECB staff projections put this at 1.3% in 2022—well below the ECB's inflation target of below, but close to, 2% in the medium term. There is real concern that inflation could become de-anchored on the downside. This would be concerning at any time, but is particularly so when debts are increasing.

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damage to the economy and the labor market. So, while Powell emphasized that a full recovery is likely to take years, the Fed's longer-run projections for GDP, unemployment, and inflation conveyed an optimistic message, showing almost no change from projections released last December.

Although the Fed offered no new programs today, the bond market nonetheless rallied. It wasn't in response to what the Fed did per se, but rather was in response to the Fed's forecasts. Although the Fed's indeterminate "Longer run" projections remain optimistic, its projections for the more finite interval through 2022 shows the economy remaining below full employment and shy of the 2% inflation target, and therefore correspondingly, requiring no interest rate hikes presumably not only over that interval, but beyond, in the view of the vast majority of meeting participants.

In contrast, in the wake of last week's strong non-farm payroll report, markets had priced in, by some measures, a substantial yield premium relative to the yield trajectory implied by the combination of the Fed's economic and interest-rate projections. In our view, today's Treasury rally removed some, but not all, of that premium.

While Treasury bonds rallied, credit products and equities were less enthused. Apparently, the so-called risk markets needed more fresh oomph in terms of new or expanded Fed programs to sustain the scorching momentum of what's already been a huge recovery since the depths of March.

Looking ahead we expect fixed income markets to remain reasonably resilient in the months ahead. Treasuries appear poised to remain relatively range bound around current levels, allowing them to outperform cash through their incremental yield and the effect of rolling down the yield curve. Today's disappointment in the risk markets notwithstanding, we expect the combination of an ongoing economic recovery — albeit uneven — combined with low Treasury yields and ongoing central bank liquidity injections to ultimately be effective in not only supporting the markets, but in fueling the ongoing search for yield and return. Outperformance of equities and credit products appears likely to continue, but at a slower pace in the months ahead that will undoubtedly bring more two-way volatility as well. As an additional caveat, with many sectors of the economy profoundly impacted by not only the virus, but also the drop in energy prices, credit selection will remain paramount.

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Second, although political momentum behind the European Recovery Programme appears promising, it will take time for any such further fiscal stimulus to feed through to the real economy. Negotiations are likely to take some time, and the suggested project areas are not "shovel ready."

Third, the German Constitutional Court ruling in May reinforced the European Court of Justice's finding that the Public Sector Purchase Plan (PSPP) element of the asset purchase programme does not violate the principle of monetary financing, which can be viewed as helpful in providing the ECB with the confidence to loosen its self-imposed issuer limits and unlock the necessary space for bold policy action. Of course, the GCC ruling does challenge the proportionality principle, but Lagarde was keen to stress that the ECB is subject to the jurisdiction of the ECJ and not the GCC. This suggests that the GCC ruling may present more of a challenge to the primacy of EU law rather the independence of the ECB per se.

So, what can we expect from the ECB going forward? It is notable that the reaction to PEPP has been in stark contrast to the restarting of QE last September. At that time, Draghi's "comprehensive policy package" drew a chorus of criticism, including—rather unusually—from high profile Governing Council members. The PEPP appears to have had more widespread support amongst the Governing Council, with even Bundesbank President Weidmann tweeting shortly after the PEPP was announced in March that "we unanimously agreed that we needed to take action and that wide-reaching measures were crucial." All of that bodes well for the ECB having started the way they mean to go.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of June 2020.

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