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Powell at Jackson Hole: Fed Doubles Up On 2% Inflation

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The Federal Reserve today announced an important change in its framework for conducting monetary policy in order to achieve its "statutory mandate from the Congress of promoting maximum employment, stable prices, and moderate long-term interest rates." One of the main changes implemented today is that the Fed will now be targeting an inflation rate of 2% on average over time, permitting – indeed, even encouraging – periods of overshooting 2% to make up for previous undershoots.

The review and this change were in part triggered by the realization that PCE inflation has spent most of the last 10 years below the Fed's 2% objective, as the unemployment rate (3.5% by the end of 2019) meanwhile was able to decline to a level much lower than previously thought possible before the pandemic hit this year. The Fed thus recognizes that the appropriate Fed funds rate over the business cycle appears now to be lower than in previous decades, and the Fed funds rate is likely to spend more time at the zero lower bound than previously expected.

In today's announced revisions to its Statement on Longer-Run Goals and Monetary Policy Strategy, the Fed is also now more explicitly recognizing financial stability risks, and their ability to derail achievement of the Fed's inflation and maximum employment goals. Powell observed in his speech today that the last few expansions have been historically long, and finally ended not with overheating inflation, but with episodes of financial instability (e.g. the Great Financial Crisis 12 years ago). Powell noted efforts undertaken in response over the past 10 years (i.e. supervisory and regulatory changes) which have significantly increased "the strength and resilience" of the financial system.

The significance of these changes to the Fed's longer-term goals and policy strategy will likely not amount to much change in what the Fed is currently doing. Indeed, Powell noted in a recent press conference that these changes will simplify codify what the Fed is currently already doing. Where today's announced changes will likely make a real difference is at a point later on in this recovery. Whereas Fed officials in the past might have begun preparations for rate hikes in anticipation of inflation potentially exceeding 2%, the new average inflation target implies the Fed will be much more patient. Today's policy framework changes thus signal a more dovish approach to monetary policy than in the past, with the caveat that the Fed will also be watching and responding to financial stability risks as appropriate. We anticipate the Fed's overall more dovish approach should, on the margin, result in higher nominal growth over time.

To the extent the markets bite down on the idea that, at least on the margin, nominal GDP will be higher under the Fed's updated framework, and the odds of the Fed hitting its inflation target higher, this should contribute to a steeper yield curve. To that point, the slope between the 2-year and 30-year Treasury, had already steepened in recent weeks from 108bp to 134bp, mostly via a rise in the yield on the 30-year Treasury.

Looking ahead, given what is likely to remain a tepid global backdrop with substantial question marks surrounding the ultimate trajectory of the recovery, the Fed is likely to remain squarely focused for some quarters, if not years, to come on boosting growth via low rates. While the net result for the rates market is likely to continue to be a relatively low level of yields, rates may be somewhat more volatile at times, however, as investors — in our view unjustifiably — remain concerned about an eventual inflation overshoot.

Overall, periods of positively sloped yield curves tend to be relatively buoyant in terms of market risk appetite, supporting our long-term view, short-term risks notwithstanding, that spread product is likely to outperform. So while the new Fed policy twist adds some uncertainty and a degree of additional upside inflation risk, the additional bit of slope in the yield curve, and economic boost to the spread sectors from the more accommodative policy bent, should ultimately prove supportive of our positive intermediate to long term bond market outlook.

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