Bond Blog

July 23, 2021

PGIM FIXED INCOME

DOES THE FED FACE AN IMPOSSIBLE TRINITY?

By Nathan Sheets, PhD, Chief Economist and Head of Global Macroeconomic Research

The stated goal of the Federal Reserve's new Flexible Average Inflation Targeting (FAIT) framework is to achieve "inflation that averages 2% over time." To meet this objective, the Fed has committed to keep rates at zero until the labor market has returned to full employment and "inflation has risen to 2% and is on track to moderately exceed 2% for some time."[1]

The Fed's framework is now getting its first serious road test. Prices of many goods have spiraled higher as demand has significantly exceeded supply and bottlenecks and shortages have emerged. In parallel, services prices are rebounding from their pandemic-induced declines. Accordingly, U.S. inflation has shown unexpected vigor in recent months and has surged substantially above 2%. The heightened uncertainties about the inflation outlook, coupled with still-unanswered questions about how the Fed's framework will actually operate and the timing of liftoff, are casting long shadows on the overall macro outlook.

With such issues in mind, this post looks at three scenarios for the U.S. economy and monetary policy, the probability that they will occur, and the challenges facing the Fed as it navigates through these potential outcomes. We conclude that each of these scenarios is plausible taken individually but, on closer inspection, we find deeper and revealing tensions as to how they would interact. As a trinity, they appear to be mutually exclusive.

First: the current bout of inflation will be transitory, and, by 2023, inflation will again be mired below 2%. The pre-pandemic deficiency of aggregate demand - reflecting the deeply-entrenched headwinds of aging demographics, high debt levels, deleveraging, and soft corporate investment - will likely restrain inflation over medium- and long-term time horizons.

Second: the Fed seeks to honor its framework and forward guidance as it vigorously pursues 2% average inflation. The Fed would suffer a blow to its credibility if it ignored or abandoned the framework so soon.

Third: the Fed will commence rate hike rates by mid-2023. With the labor market rebounding and output likely well above potential, the Fed will have ample justification for rate liftoff. Notably, this timing would be a notch slower than current market pricing and broadly consistent with the Fed's dot plot.

The tension between the scenarios arises from the Fed's commitment to not hike rates until inflation exceeds 2% and is "on track" to moderately exceed 2% for some time. If inflation in 2023 reverts to its pre-pandemic contours, as suggested by the first scenario, this condition for rate hikes is unlikely to be satisfied. Stated bluntly, to justify higher policy rates, the Fed needs to see sustainable 2% inflation and have confidence that inflation is poised to move higher. The whole idea of the framework is to drive inflation above its pre-pandemic pace.

But the vexing question is which of these scenarios might fail to materialize. Does inflation run hotter than in the years before the pandemic? If not, does the Fed delay rate hikes beyond 2023 in an effort to drive up inflation and inflation expectations? Or does the Fed set aside its framework or, more likely, stretch it beyond recognition at the risk of its credibility?

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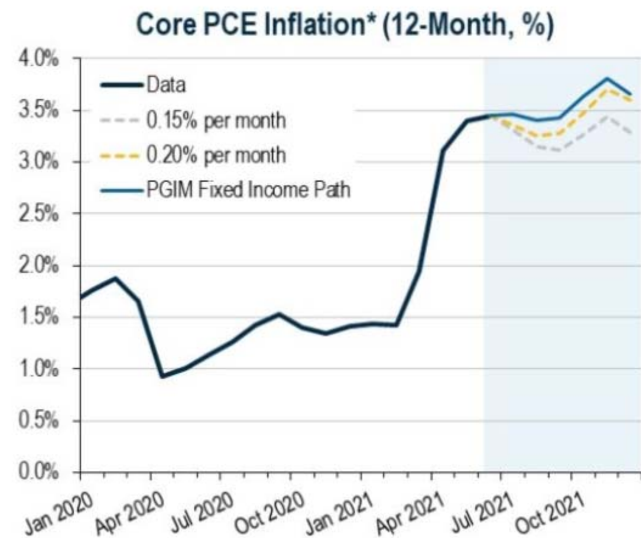
Can the Tension Be Reconciled?

At first blush, it may seem that the tensions between these scenarios can be reconciled. One natural argument is that inflation is currently running well over the Fed's 2% target. Indeed, by our reckoning, core PCE inflation by the end of this year will have made up more than five years' worth of undershoots (see Figure 1). In other words, given this year's surge in prices, the five-year average for core PCE will likely be above 2%. With this in hand, can't the Fed legitimately claim that it has satisfied its framework and begin hiking rates?

FIGURE 1: CORE PCE INFLATION (12-MONTH, %)

	0.20 M/M Per Month	0.15 M/M Per Month	PGIM Fixed Income Path*	
	12-Month		M/M	12-Month
Oct-20	1.40	1.40	0.00	1.40
Nov-20	1.34	1.34	-0.01	1.34
Dec-20	1.41	1.41	0.29	1.41
Jan-21	1.43	1.43	0.20	1.43
Feb-21	1.43	1.43	0.15	1.43
Mar-21	1.95	1.95	0.42	1.95
Apr-21	3.11	3.11	0.70	3.11
May-21	3.39	3.39	0.48	3.39
Jun-21	3.45	3.45	**0.40**	**3.45**
Jul-21	3.36	3.31	0.30	3.47
Aug-21	3.25	3.15	0.25	3.40
Sep-21	3.27	3.12	0.20	3.43
Oct-21	3.48	3.27	0.20	3.63
Nov-21	3.70	3.44	0.15	3.80
Dec-21	3.60	3.29	0.15	3.65



Source: PGIM Fixed Income as of July 2021. *Blue shading indicates estimates through December 2021.

This argument has three flaws. First, the underlying goal of the Fed's framework is to durably raise inflation expectations and, hence, achieve 2% average inflation in the years ahead. Fed Chair Powell appears to be in the camp of the first scenario: he has forcefully characterized the current inflationary episode as "transitory." Transitory inflation, by definition, abates and is unlikely to sustainably lift inflation expectations.

Second, and even more pointedly, the recent surge in prices has been exceptionally concentrated, with large jumps in the auto sector - e.g., 55 bps of the 88 bps increase in the June core CPI report - accounting for a disproportionate share of the increase. These elevated prices may very well fall back toward previous levels, reversing some portion of the prior months' inflationary impulse and possibly leading to a disinflationary impulse.

Third, the forward guidance associated with the framework indicates that, in order to hike, the Fed needs inflation to be at 2% and "on track to moderately exceed 2% for some time." Importantly, this is a forward looking - not a backward looking - condition. The recent price surge is clearly exceptional, but tells us very little about the economy's future performance. To achieve its objectives and raise inflation expectations more durably, the Fed must allow more organic and long-lived inflation pressures to take hold.

Yet another rejoinder, however, is that the "F" in FAIT stands for "flexible." The Fed has left itself ample discretion to act as it sees fit. More concretely, if the next year or two brings a labor market recovery, sustained solid growth, and the possibility of financial stability risks, the case for hiking rates will be strong - even if inflation remains softer than the Fed would like. But, to be clear, such action would harken to the Greenspan days of "risk management" rather than a Powell-chaired Fed driven by a novel framework. The critical, but implicit, question is how appropriate the framework will be for the post-pandemic world.

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The Plausibility of Outcomes and Risks

We see all three of the scenarios as plausible outcomes but, without trying to put too fine a point on things, we would also assign each a probability of roughly one-third of not occurring. With inflation surging at present, it's impossible to be entirely confident that its medium-term trajectory won't be affected. Similarly, coming out of the financial crisis, the Fed took more than five years before hiking rates. Of course, the pandemic has been a dramatically different experience, but the post-financial crisis episode nevertheless looms large, and the Fed may wait until after 2023 to hike rates. There is also a chance that the Fed will ultimately determine that FAIT was suitable for a post-GFC world, but not a post-pandemic world, and take subtle steps to sideline the framework.

While our trinity with equivalent probabilities may appear non-committal, it underscores the unusual uncertainties and fine lines that Fed policy and communication must negotiate, including at the upcoming FOMC meeting. With all three scenarios still in play, a communication misstep risks opening another set of scenarios, which could range from wrong-footing the markets to painfully walking back previous statements. While the markets may be first to flag a shift in the trinity's delicate balance, it is one that will also require ongoing attention from policy observers and the Fed itself.

[1] Federal Reserve Issues FOMC Statement, June 16, 2021

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