2 September 2020

Fed Monitor

Forward guidance linked to inflation outcomes and faster QE buying on the cards

Key takeaways

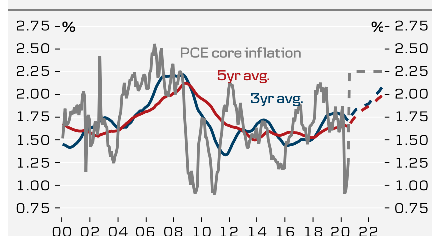
- **The Fed has changed its reaction function in two important ways**. 1) It will no longer tighten monetary policy just because unemployment is low if wage and inflation pressure is subdued and 2) The Fed will tolerate inflation above 2% without tightening monetary policy.
- **Fed call.** We expect the Federal Reserve to change its forward guidance stating that the Fed funds target range will not be lifted 'until inflation will run above 2% for some time'. We also think the statement will include more references to inflation expectations. We expect QE buying to be linked to inflation as well and think a faster buying pace is on the cards (although it is not a high conviction call).
- **Risk.** Actions speak louder than words and unfortunately we see a risk that the Federal Reserve does not deliver that much at the upcoming meeting. If so the Federal Reserve may join the club of central banks with '0% rates and QE buying forever' if it fails in building up credibility right away. This is also why easing more is necessary at the upcoming meeting.
- **FX.** On balance, the Fed's policy combined with (our expectations of) global macro means EUR/USD is likely to trade in the 1.18-1.20 range with risks tilted to the upside, especially on a 3M horizon. See details on page 4.
- **Equities.** No matter how the Fed intends to implement the policy shift it means that monetary policy will be more important for equities near-term. Details on page 5.
- **Fixed income.** We argue that 10Y US real rates are next to move higher, and that the real-rate gap will be slightly less negative. In our view it will mainly be US nominal yields that will move higher. Details on pages 5-6.

The Fed has shifted to a flexible average inflation targeting regime

Although the official announcement came earlier than anticipated, it was not a big surprise that the Fed has now formally changed its monetary policy regime to a flexible average 2% inflation target away from a traditional 2% inflation target. The journey to the change has been long and we started the discussions on the topic in *Research US: The subtle push for price level targeting continues*, 3 January 2018. Basically, **the regime shift means that the Fed now allows inflation to overshoot the 2% target for some time to make up for a period of time with inflation running below 2% such that inflation on average is 2%.** We think this is a very positive step, as it means the Fed is now more determined in creating inflation than before, whereas the 2% target was thought as a ceiling under the old regime.

An illustrative example. If the Fed wants the 3-yr PCE core inflation average to run around 2%, the Fed needs to create 2.25% y/y core inflation every month through 2022. The Fed has not succeeded with such high inflation on this side of the financial crisis.

Illustration: PCE core inflation needs to run at 2.25% y/y every month through 2022 to get the 3-5yr average back to 2%



Sources: BEA, Macrobond Financial, Danske Bank illustration

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Two important changes to the Fed's reaction function

The new regime means the Fed's reaction function changes in two important ways. **Firstly, the Fed will no longer tighten monetary policy just because unemployment is low** if wage and inflation pressure are subdued. This is very different from the way former Fed chair Janet Yellen and Ben Bernanke conducted monetary policy, as they started tightening monetary policy because unemployment was declining and they thought inflation would follow suit. This did not happen. **Secondly, the Fed will now allow inflation to move above 2% without tightening monetary policy**.

In the current situation, this means that the Fed will not tighten monetary policy, even if the economic recovery after COVID-19 proves stronger than what we and the Fed currently expect. Investors are right in pricing zero rate hikes in coming years. We do not expect a repricing of the Fed in a hawkish direction.

As we wrote above, we think this is a very positive step, as we will avoid a repetition of the tightening of monetary policy in 2013-2018 (in line with what Fed governor Lael Brainard said yesterday), and should support the reflation trade. **That said, there are also some questions, which the Fed needs to answer to make the regime more credible and hence effective, in our view**. The formulation of the average inflation targeting is quite vague at this point, which may make sense, given that this is about the long-run goals and not how to fulfil them, which the FOMC meeting statements are for. **How high can the Fed tolerate inflation going? And for how long? Fed chair Powell clearly rejected a formulaic approach, as the Fed wants to keep some flexibility**. **This, however, also means that the regime is less credible than it could have been, as the Fed is not completely tying its hands.** A stronger approach would have been to make an explicit price level target, which the Fed however rejected early in the process. From a theoretical perspective, the stronger the commitment, the stronger the impact on the economy, something we discussed in *Fed Monitor: A primer on the Fed's discussions on changing its forward guidance*, 17 June.

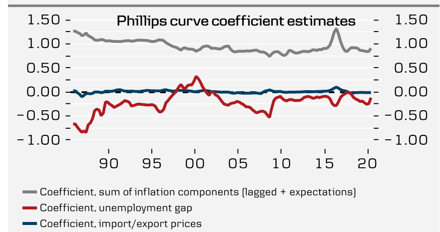
Another question is what will the Fed do to create inflation? Right now inflation expectations remain subdued from a historical perspective and actual inflation has been running persistently below 2% for many years now, so **the Fed should ease more, but it has actually tightened monetary policy by slowing QE buying in recent months**. It is very important that the Fed makes the new regime credible right away, otherwise it risks a 'Bank of Japan moment', which has not succeeded with its shift to a 2% inflation target. This means that the Fed needs to do something at the upcoming meeting next month. There is clearly a risk that this means '0% rates and QE buying forever'.

Fed is set to change a few things but remember actions speak louder than words

We believe the shift to average inflation targeting including the ditching of the 'Phillips curve thinking' from the Bernanke and Yellen era in itself is a big step forward and markets have bought into it by sending breakeven inflation rates higher. The Fed clearly wants to avoid a repetition of the 2013-2018 tightening, which slowed the rebound after the financial crisis, in line with what Fed governor Lael Brainard said yesterday.

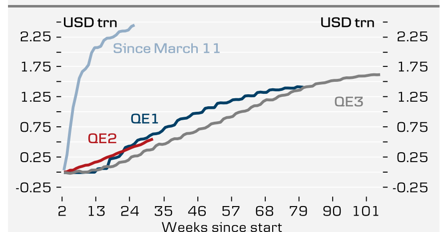
In our view, the Fed has sent somewhat mixed signals. On one hand, the minutes from the July meeting stated that *'several participants suggested that additional accommodation could be required'* and *'a number of participants noted that providing greater clarity regarding the likely path of the target range for the federal funds rate would be appropriate at some point'*. On the other hand, based on Powell's speech and comments from other FOMC members afterwards, the Fed has ruled out a mechanical/technical rule. However,

Inflation expectations drive inflation, not the unemployment rate



Sources: BEA, BLS, Macrobond Financial, Danske Bank model

QE buying has slowed despite still subdued inflation expectations

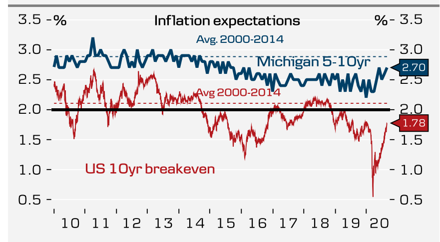


Sources: Federal Reserve, Macrobond Financial

Fed governor Lael Brainard stated yesterday that the Fed should move in a more accommodative direction.

The next statement is obviously going to include references to the new regime but the question is to what extent. **We think it is likely that the Fed will change its current forward guidance to *'The Committee expects to maintain this target range until it is confident that inflation will run above 2% for some time'*** (currently *'The Committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals'*). Other changes would require more commitment and would be in conflict with the Fed saying that it does not want a mechanical/formulaic rule. In our view, it would be a good idea for the Fed to be more specific on how high the committee can tolerate inflation going and what period it is looking at, especially as credibility is everything when you shift regime. A good guess, however, is that they will be looking at a 3-5yr average inflation, which is the same horizon of the yield curve control policy they discussed in the summer. **We also expect more comments on different inflation expectations measures in the statement, as vice chair Clarida was alluding to by talking about inflation expectations still *'at the low end of the range I consider consistent with our 2 percent inflation goal'*.** This alone suggests the Fed should ease more, not just stick to its current policy stance and hope for the best.

Fed will look more closely at different measures of inflation expectations going forward

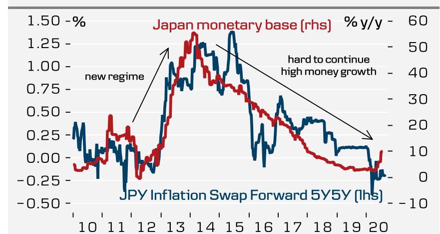


Note: Past performance is not a reliable indicator of current or future results.
Sources: Michigan, Bloomberg, Macrobond Financial, Danske Bank

It seems clear to us that something will happen on QE, as the last minutes stated that *'many participants commented that it might become appropriate to frame communications regarding the Committee's ongoing asset purchases more in terms of their role in fostering accommodative financial conditions and support economic recovery'*. **At least the QE programme will be linked to inflation following the new policy regime, in our view.** We think the Fed will keep the flexibility by not indicating an end date, as the open-ended nature of the QE programme has worked well. **However, we also think it is more likely than not (although not a high conviction call) that the Fed will increase QE buying again, as it has slowed in recent months. We think the Fed could state that it will 'increase the current pace' of bond buying.** This seems like the easiest way to continue high money growth and send a signal that the Federal Reserve wants to do what it takes to deliver on its new regime. A very straight way forward would be for the Fed to buy more inflation-linked bonds, which would be a strong signal that it believes in its own new regime.

Although we think the Fed will deliver something to send a strong signal that it is committed to its new regime, we also stress there is a risk that the Fed is another place and that this is instead just a way of saying that it will stick to its current stance for a long time. **Actions speak louder than words and the risk is that the Fed will join the club of central banks with '0% rates and QE buying forever' if it does not go a long way to fulfil its new objectives.** This is exactly what happened for Bank of Japan when it changed to its 2% inflation target. Initially, the Bank of Japan increased money growth significantly and inflation expectations followed suit. After that, money growth started to decline and so did inflation expectations. Despite the Fed's track record, it is difficult for central banks to 'commit to be irresponsible'.

Bank of Japan shows it is difficult to make a credible regime shift over time



Note: Past performance is not a reliable indicator of current or future results.
Sources: Bank of Japan, Macrobond Financial, Danske Bank

The Fed is also likely to continue calling for another fiscal relief package. In particular, an extension of the higher unemployment benefits, as not all people are able to return to work yet, and another round of stimulus cheques to households would be good from a Fed perspective. Unfortunately, the Republicans and the Democrats have not been able to reach a deal yet and negotiations may not restart until after Labor Day on 7 September. The US election on 3 November only complicates things. Note we have a looming government shutdown on 1 October, as the current funding bill expires on 30 September.

The Fed also has other options, but we do not think the Fed will go down those roads. We still believe the Fed is reluctant to cut rates into negative territory despite the regime shift. The idea of yield curve control still lives among some of the FOMC members but is not expected at this point and should not be necessary if the new regime is credible. Hence we do not expect it to be announced. The Fed is not allowed to buy a broader class of assets unless legislation changes. Fed Chair Powell has also made it clear that the Fed has 'lending power, not spending power', and hence it seems unlikely that the Fed will make something like 'People's QE', where it sends people money directly instead of through the banking system.

FX: average inflation targeting limits the chances of near-term USD appreciation

With a credible Fed commitment as a key backdrop, we stress three key FX takeaways of flexible average inflation targeting. **First Emerging Markets are first in line to benefit from easy dollar liquidity conditions. Second, enhanced Fed communication limits the risk of a negative global shock via USD appreciation. Third, EUR/USD will implicitly benefit.**

That said, specifically for EUR/USD, the implications of FAIT are not obvious as relative inflation has not directly been a relevant factor in the cross for many years. But, the new policy is implicitly EUR positive, as the US is effectively exporting easy financial conditions to the rest of the world. The Fed's loose stance also means a potential US fiscal package could have positive spill-over effects through the current-account deficit, benefiting European autos and industrials alike. Rising global inflation expectations also suppress debt-deflation and political risks, which are particularly prominent in the euro zone. If the Fed succeeds in strengthening global demand, it will thus also find its way to EUR/USD indirectly.

Near term, the focus for the pair turns to the September FOMC meeting, global economic activity, the value versus growth rotation in equity markets and the potential for further US fiscal easing. These factors may shift EUR/USD around from day-to-day, but it is quite hard to see a shift to substantial USD appreciation on a 3M horizon.

A key thing to keep in mind is that we now see a rise in the broad (effective) EUR as weighing somewhat on European equity markets. This may make the ECB reflect and verbally try to intervene against excessively rapid appreciation. In addition, the still-somewhat-slow pace of the global economic recovery limits the potential for near-term. EUR appreciation. So, 1.25 is likely not in sight right now. Looking further ahead, Europe still has an ample supply of internal problems that are likely to matter on a 12M horizon, but these EUR negatives can easily be overshadowed by a renewed pick-up in global market sentiment for the time being.

On balance, the Fed's policy combined with (our expectations of) global macro means EUR/USD is likely to trade in the 1.18-1.20 range with risks tilted to the upside, especially on a 3M horizon.

Equities: monetary policy more important near-term

With the new policy framework presented yesterday, Jerome Powell made it even harder for equity investors to structure their portfolios optimally in the near future. **Without informing on how to implement the new policy, he left investors with more questions than answers**. This was quite visible in the market reaction on Thursday, where investors did not know which way to run. Most equity markets ended higher but at the same time the implied volatility measured by the VIX spiked from 23 to 27 intraday.

The key question for equity investors will be whether the new policy initiatives, whatever they might be, will dominate the effects of higher inflation volatility and the prospects of a steeper yield curve. **We do not think the Fed will disappoint and thereby also assume it will undertake sufficient loosening to support a further rally in equities**. However, we see the biggest impact being on the different equity factors and not least the appetite for growth over value stocks. **A steeper yield curve at this point of time will result in some big shift in the market as both the relative valuation and position leaves room for a big outperformance of value stocks.**

For the regional allocation, this will be determined by how the bond market reacts to this policy change. If the Fed initiates further stimulus at the September meeting via additional QE it will mean further outperformance for US equities. However, if it applies other tools which primarily lead to a steeper curve it will be more supportive for European stocks.

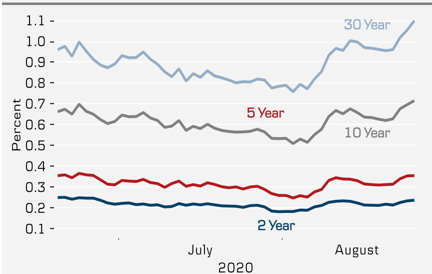
No matter how the Fed intends to implement the policy shift it means that monetary policy will be more important for equities near-term. It also means that we could see higher volatility in the coming period as feasible outcomes have increased.

Fixed-income: US real rates to move higher on higher nominal rates

The Fed regime-change had a significant impact on the US curve especially the long-end, where 30Y yields jumped by 15bp. 10Y yields rose 10bp. Hence, **we have seen a clear steepening of the US curve.**

But, importantly, **the impact on the first five years of the curve was very muted and investors are pricing that rates will stay at zero for several years**. The market is currently pricing that Fed funds will be 25bp higher in late 2024. The market is pricing a small probability that Fed funds can go negative over the next couple of years. It should be underlined that there were no indications that the Fed is considering going down the negative rate path.

US Treasury yields higher



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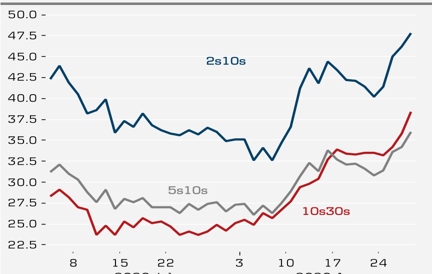
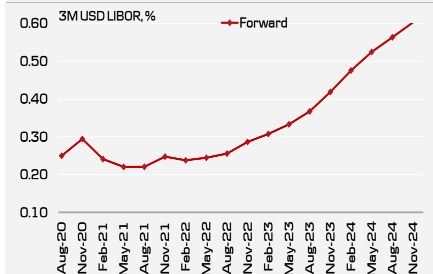
US Treasury curve steeper



Source: Danske Bank. Note: Past performance is not a reliable indicator of current or future results

First rate hike not priced before 2024



Source: Danske Bank. Note: Past performance is not a reliable indicator of current or future results

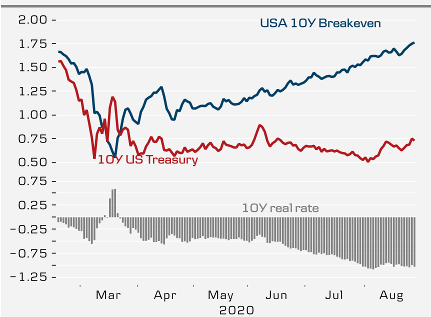
In light of the new regime from the Fed, it is noteworthy that US break-evens (inflation expectations) have moved higher since March and despite the COVID-19 crisis the level is

not back to the 2019 level. Nominal yields and rates have not followed suit, however. It has pushed US real rates down well into negative territory.

We did see that US break-evens continued higher after Powell's speech. But note that especially in the 30Y segment real rates have started to move higher. **We argue that 10Y US real rates are next to move higher, and that the real-rate gap will be slightly less negative. In our view it will mainly be US nominal yields that will move higher**.

But why should 10Y real rates move higher? Simple, because the real rate today is too low relative to most estimates that put US neutral real rate (r*) above zero. It is difficult to argue that the COVID19 crisis has changed the neutral real rate to negative in the US on a permanent basis. If 10Y real rates stay negative at -1% we argue that it would be due to both inflation expectations and nominal rates/yields moving higher.

Big negative real-rate gap in the 10Y segment, %



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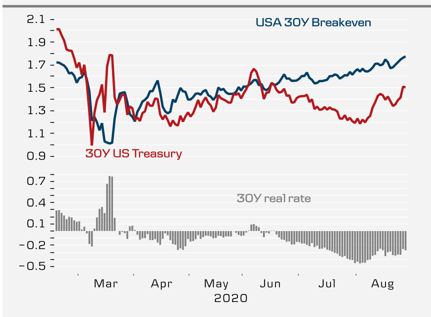
The real-rate gap is closing in the 30Y segment, %



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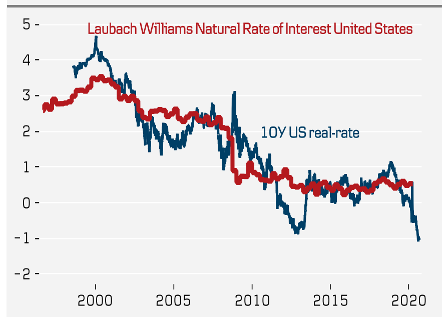
Current 10Y real rate well below the current neutral real-rate, r*



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