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Bond Bites

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A twist of FAIT

Changes to monetary policy frameworks are rare and significant events. So what could be the impact of the Fed's view on employment and the new Flexible Average Inflation Targeting (FAIT)?

Enforced periods of working from home can bring unexpected benefits, not least a heightened appreciation of our surroundings. I am fortunate to live in a corner of England that is officially recognized as an Area of Outstanding Natural Beauty. But a stroll through the hedgerows and hillsides of the North Downs Way can yield some strange and disturbing sights; decaying pillboxes with fields-of-fire that cover only columns of advancing wild-flowers. Tank traps that resist the spread of vineyards across the hillside and the rotting concrete foundations of anti-aircraft guns that today provide shelter for a family of llamas[1]. These are actually the decaying remains of what was known as the Outer London Defence Ring. Built hastily in 1940, ahead of the expected invasion, it was planned as the final stand in a desperate, last-ditch, and probably doomed defence of London. As it happened, the pivotal battle was fought out instead in the skies overhead and not on the ground; the second miracle of that summer. The carefully laid fortifications were thankfully never needed and the strategic defence of this country was completely rethought.

Across all walks of life, carefully laid plans can require a radical rethink in the face of an evolving situation on the ground. Central banks are no exception. Reworking *their* approach to achieving monetary goals can leave a marked impression on the investment landscape for years ahead.

The US Federal Reserve (Fed) recently announced two important changes to its monetary policy framework[2]. At first glance, these seem subtle and unremarkable but in the longer run may have important implications for investors.

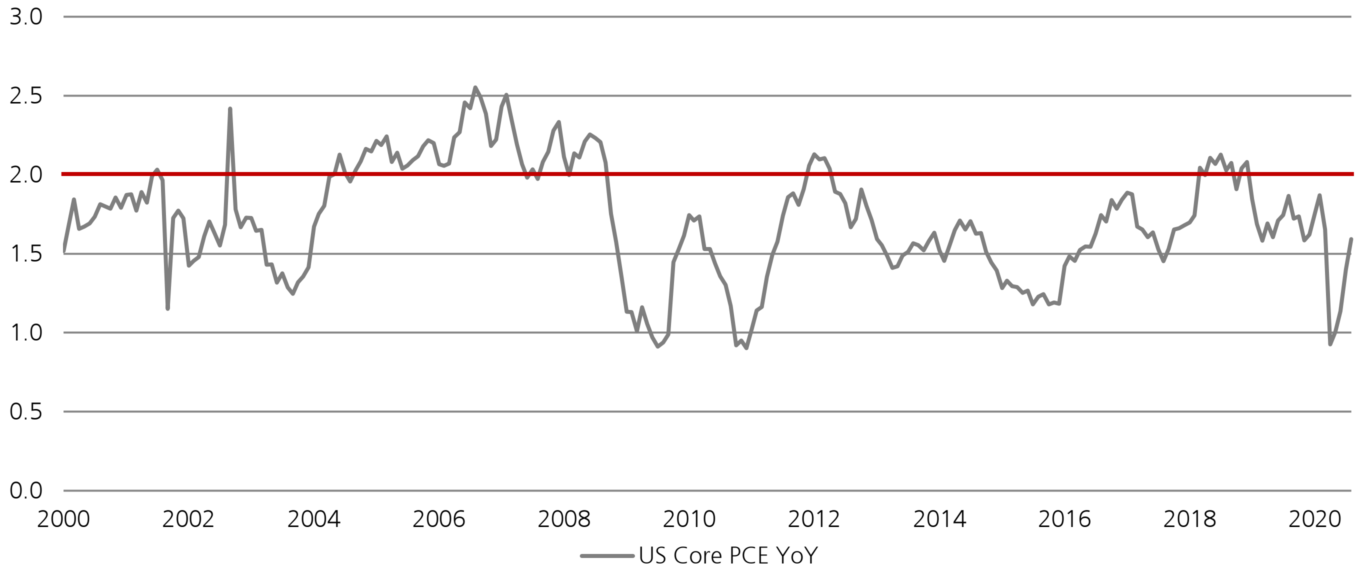
One change is a new way to manage the inflation objective, now called Flexible Average Inflation Targeting (FAIT), even though the long-run goal continues to be an inflation rate of 2%. Until now this goal had effectively worked as a ceiling, with the Fed adjusting rates to bring it back to target whenever forecast inflation deviated too much. However, the new approach will aim for inflation that *averages* 2% over time. The point being that realized inflation will now be allowed to run above 2% to 'make-up' for periods when it has run below target.

The second change is to the Fed's view of the labor market as a leading indicator of inflation. Prior to the Global Financial Crisis of 2008/9 there had been a relatively strong link between wage growth and inflation (higher wages fed quickly into higher prices). Changes in employment levels, which drive changes in wages, were very important to decision making for the Fed, and many other central banks. As a result, rate cycles became correlated with wage growth. But since 2008 this relationship has completely broken down, and noticeably so in the US. So, from now on, the Fed has said that changes in employment will play a far less central role in shaping monetary policy decisions[3].

Why is this important for investors?

At first glance it is easy to be dismissive that FAIT is at all meaningful. The Fed (with other central banks), has consistently failed to hit the 2% inflation target as it is, let alone see inflation run *above* target. (Chart 1 shows US inflation, represented by the Personal Consumption Expenditure Index, has undershot the target of 2% for most of the past 10 years).

Chart 1 – Personal consumption expenditure index



Source: Bloomberg. Data as at 31 August 2020

Index description: The personal consumption expenditure price index is one measure of U.S. inflation, tracking the change in prices of goods and services purchased by consumers throughout the economy.

Ever since the Global Financial Crisis it has consistently expressed confidence that the target will be hit "in the medium term", but the medium term then stubbornly refused to arrive. References to inflation undershoots as "transitory" have been incredibly enduring. And today we now face the patently deflationary effects of COVID-19 that will likely prevail for at least another year or so.

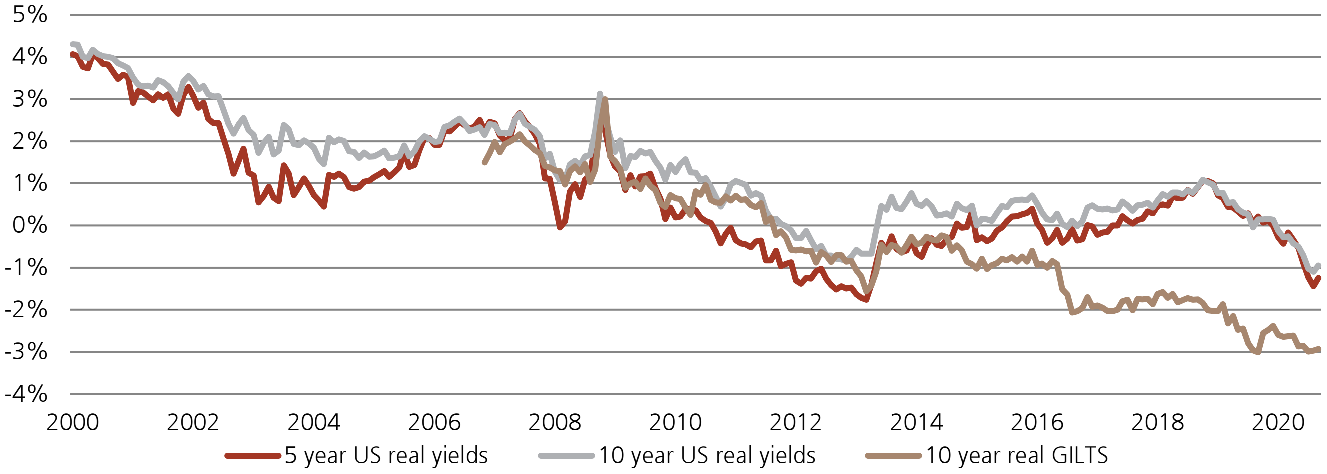
So skepticism about FAIT's significance can be justified. After all, maybe it's not the inflation target that is the problem but the ineffectiveness of monetary policy *alone* to achieve it? *But that's exactly the point.* It is possible that a number of developments today, such as the sudden dramatic expansion of fiscal policy (entirely absent from most developed markets over the past 10 years) and a shift in other structural drivers of inflation[4], mean the US is already transitioning to a more inflationary environment.

We cannot be completely sure and many will still argue that the primary risk is deflation. That may be so but if inflation does start to pick up what might FAIT mean?

1. **Official rates will still stay low for a very long time.** By some estimates and based on the Fed's own economic projections, the first rate hike could be as far away as 2025. Higher inflation projections and falling unemployment will not trigger a response in the way they once did. The Fed's precondition now for higher rates will be *actual* inflation of at least 2% and projections for it to exceed that level "for some time". So we will have to get used to a world where the Fed will let the economy run hotter even if inflation starts to accelerate.

2. **Real yields could go even lower**. Given a base case for the Fed to keep rates on hold, even as growth and inflation accelerate, the likelihood is that real yields (i.e. yields after inflation) will be even lower. Chart 2 highlights how real yields in the US moved into negative territory earlier this year – partly in response to a much weaker economic outlook. But the Fed's policy may lead to an extended period of negative real yields – this would mirror the experience in some other countries, for example the UK, where real yields have been negative for almost all the past 10 years. Investors will need to adapt to a world where negative real yields are the norm, not the exception.

Chart 2 – Evolution of US Treasury and UK Gilt real yields



Source: Bloomberg Barclays data as at 30 September 2020.

3. **Potentially higher asset price volatility;** the new approach means that the Fed will not be in any rush to increase rates even as inflation, and inflation expectations, start to rise. This will be quite a break from tradition. But does FAIT now mean the Fed would let inflation run above 2% until all those cumulated misses have been recovered? We don't know. The Fed talks about allowing inflation to run "moderately" above 2% "for some time" but none of us know exactly what this will mean in practice. But greater uncertainty around the path of policy rates and higher upside risks to inflation will affect asset prices.

4. **There is a gap in our understanding of how decisions will be made**. As mentioned, central banks and investors have paid close attention to wage and employment data as an important forward-looking indicator for the path of inflation. Given the breakdown in that relationship, the Fed has now jettisoned employment data in its rate setting framework. That seems fair enough but it is not obvious what has replaced it in the Fed's thinking around what really drives inflation. Without that anchor, communication and transparency around policy setting could be more challenging.

5. **All else being equal it could pose a headwind for the USD.** At face value an economy with higher upside risks to inflation, lower policy rates for even longer, uncertainty about the path of rates and more volatile asset prices as a result, is one that is less appealing to foreign investors. So downside risks for the dollar have also increased. This could be especially supportive for emerging market bonds, so flexibility in the market and currency allocation will become more important.

6. **Where the Fed leads, other central banks can follow**. Structurally low inflation, high savings rates and a breakdown in the link between employment and inflation are global issues, which don't just impact the US. So, expect a similar policy shift, and associated consequences, in other developed markets. The European Central Bank (ECB) looks highly likely to follow suit given its own monetary policy framework review. And in global markets everything is connected. If the Fed's shift implies a weaker dollar then other countries will take steps to restore the status-quo.

Of course, it is impossible to be completely sure about the full impact of the new paradigm. But changes in monetary policy frameworks tend to be significant events, not always well understood at the time (after all, very few imagined that the introduction of inflation targeting regimes in the 1990's would herald an age of zero interest rates 20 or so years later). And the Fed plays a hugely significant role in the global economy, given the US dollar's reserve currency status and US Treasuries' station as the asset against which others are valued.

To read more about how my colleagues and I reflect some of these risks in our global portfolios and for more thoughts on the global and regional outlooks please click here

Read our related paper: When will inflation return?

1 The landowners around here are an eccentric bunch

2 https://www.federalreserve.gov/newsevents/speech/powell20200827a.htm

3 In effect the Fed is placing far less emphasis on the so called 'Phillips curve' which historically has shown a stable and inverse relationship between inflation and unemployment

4 These include challenges to the global supply chain, trade-wars, supply-side constraints and a serious counter revolution against the drivers of inequality

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