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# Experimental Policy, Inflation Risk and Investment Markets

Our weekly macroeconomic view.

07 September 2020

# The Experiment

The US Federal Reserve recently announced an important change in its framework for conducting monetary policy to achieve its mandate of "promoting maximum employment and stable prices".

The Fed will now be targeting an inflation rate of 2% on average over time, permitting periods of overshooting 2% to make up for previous undershoots.

This change was in part triggered by the realisation that the Fed's preferred measure of inflation, the personal consumption expenditure measure (PCE), has spent most of the last 10 years below the Fed's 2% objective, while the unemployment rate (3.5% by the end of 2019) was able to decline to a level much lower than previously thought possible (before the pandemic hit) without generating much inflation.

**US inflation (Core PCE)**


Source: Refinitiv, Wilsons

## Inflation Vigilance takes a Backseat to Full Employment

While the immediate implication is not huge, the announced changes may well make a real difference later on in the 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 and be prepared to let the economy "run hot".

The move underscores the determination of the US central bank to keep rates near zero, possibly for years, to help the economy recover from the coronavirus-induced recession. The Fed is likely to remain squarely focused for years to come on boosting growth and reducing unemployment via near-zero cash rates and a controlled long bond yield.

Equities like a solidly growing economy with a moderate degree of inflation, so the approach should be supportive for equities, at least over the medium-term.

A key question for investors is whether this shift in policy will lead to a marked acceleration of inflation at some point in the recovery, which could ultimately be damaging for equities and very unpleasant for bonds, or will the structural drivers of low inflation in recent decades persist?

## What if Inflation is Already Dead?

While the Fed will do its best to encourage a pick-up in both growth and inflation, will it be enough? The severity of the COVID-19 shock is likely to lead to intense disinflationary (or even deflationary) pressures in the near-term, while a strong recovery likely hinges on a successful vaccine. In its absence, we would likely face a very tepid recovery which would mean that inflation would stay very subdued.

The experience of other countries also suggests that success isn't guaranteed. We have had more than 20 years of very aggressive policy in Japan, and we have seen neither inflation nor strong growth there. The Bank of Japan introduced an "inflation-overshooting commitment" in 2016, with not much success.

The post-global financial crisis (GFC) global environment has been one of relatively low growth and low inflation. The structural forces that have been keeping a lid on the growth and inflation environment include globalisation, an ageing population and high debt levels. Inflation has also been held down by a highly competitive and increasingly disrupted business environment with the internet a key enabler of intense price competition.

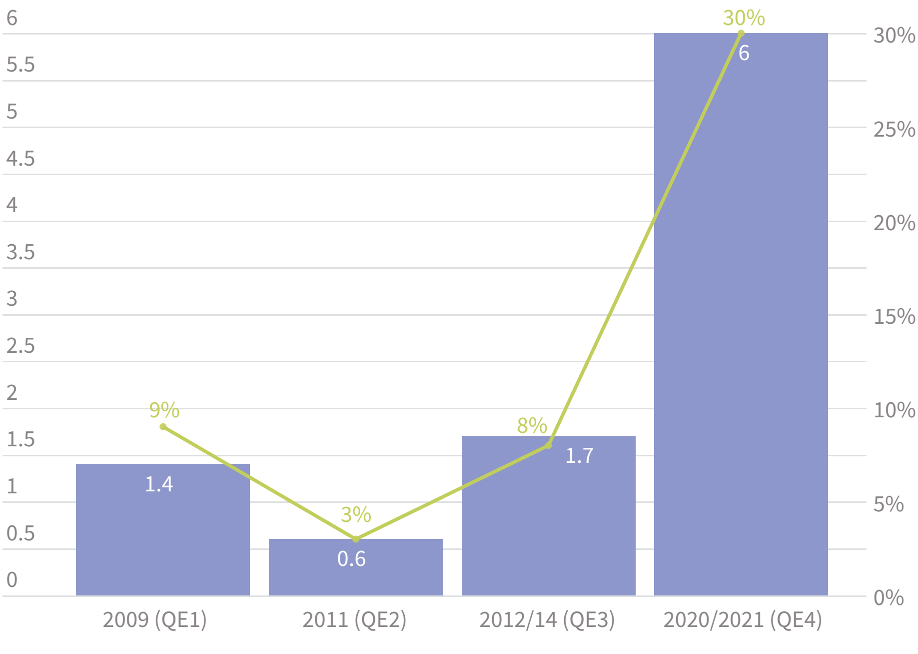
These low inflation drivers are unlikely to disappear, though one of the important disinflationary influences in the last few decades, globalisation, has likely passed its peak. This should add something to inflation pressure at the margin. This, alongside a policy backdrop that is likely to be very pro-growth for an extended period, suggests the post-GFC experience of low growth and low inflation backdrop may not repeat exactly as before.

## Unchartered Policy – To Infinity and Beyond?

The Fed's policy shift takes on additional importance when viewed against the broader backdrop of massive monetary and fiscal stimulus now in place not just in the US, but across the world.

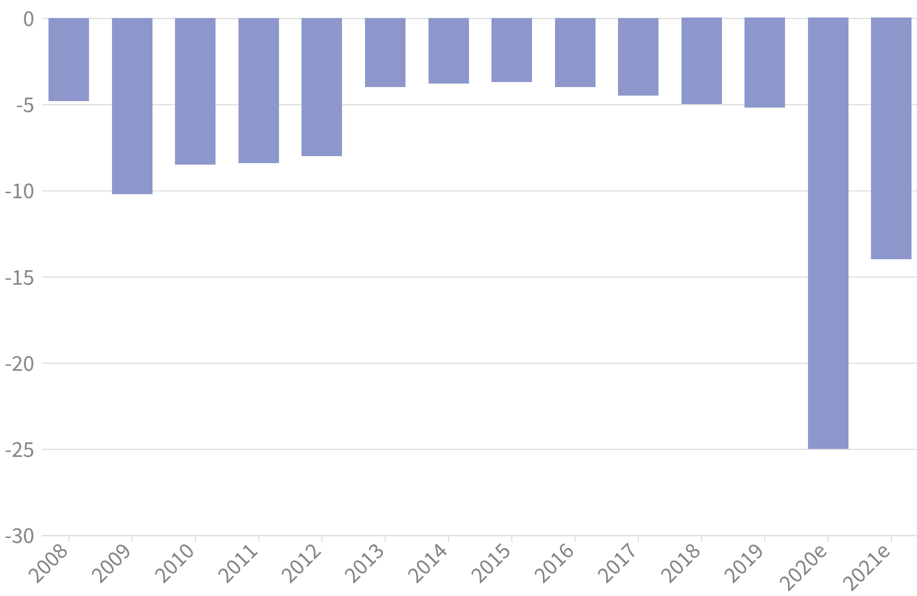
Policy easing this year has been timely, global and truly massive in scale. Policy action this time was swift because the (COVID-19) shock was exogenous. Policymakers did not hold back in the face of a global health crisis. The Federal Reserve's balance sheet has ballooned following their March 2020 announcement to restart quantitative easing. It reached 7 trillion US dollars as of August. Indeed the Fed's balance sheet will likely rise to 30% of GDP by end-2021, more than QE1, 2 and 3 combined. In addition, the fiscal deficit in the US will likely rise to at least 25% of GDP in 2020. More broadly, the G4 central banks are forecast to expand their balance sheets by 28% of GDP by end-2021, and the G4 and China economies are extending fiscal support of 17% of GDP in 2020. This is a combined policy stimulus that dwarfs the post-GFC environment.

**Exhibit 2: US Fed balance sheet expansion**




Source: US Federal Reserve

**Exhibit 3: US Federal Government Fiscal Deficit (%GDP)**




Source: US Treasury

## The Case for Higher Inflation - Too Early to Call but be Prepared

With so much policy stimulus in train and a more pro-growth attitude from policymakers, we think there is a reasonable case that inflation will ultimately overshoot the Fed's target in this cycle.

Market indicators of inflation indicate a shift in attitudes in recent months with the 5 year breakeven inflation now at 1.5% vs a trough of 0.2% in mid-March. But the market is still a long way from even pricing in the Feds central target let alone an overshoot. Nominal bonds yields at 0.70 basis points will ultimately be vulnerable to a move up in inflation, though holding down bond yields via QE is part of the Fed's policy plan, at least for the next couple of years.

The road to higher inflation will be a journey. To get to the above-trend inflation stage (i.e., inflation getting above central banks' target range), we think we will have to negotiate a disinflationary period as the COVID-19 shock weighs on demand, before giving way to a reflation phase as the economy recovers. A sweet spot of good growth and moderate inflation should support equities and other risk assets. This phase could run for several years.

However, this goldilocks phase is unlikely to last forever. Inflation and bond yields are likely to move up eventually. This may not be high inflation in the historical sense, but it may be significantly more than is currently priced. We believe investors need to be cognisant of the value of inflation hedges and alert to the potential for different leadership patterns within equities, as well as the potential for adjustments in equity valuations.

Read our Case for Inflation-Linked Bonds and for Gold in Multi-Asset Portfolios and our piece on The Global Equities Revival.

**Exhibit 4: S&P500 and bond yields (bonds have barely budged so far in the equity revival)**


Source: Refinitiv, Wilsons

**Exhibit 5: S&P500 and inflation breakevens (however expected inflation is rising)**


Source: Refinitiv, Wilsons

## Watch the Experiment Closely

The shift from the US Fed in being more prepared to tolerate higher inflation for stronger growth and employment outcomes is an interesting one. This is particularly so when viewed against the broader backdrop of massive monetary and fiscal stimulus not just in the US, but across the world. The return of inflation is, of course, by no means a certainty. The world is attempting to emerge from a deep economic contraction, while the structural drivers of low inflation and structural headwinds to growth are still significant. Nonetheless, investors need to acknowledge that an unprecedented policy experiment is underway. Economic and investment markets trends may not necessarily be in line with those of the last 5-10 years.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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