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ECONOMIC & MARKET REVIEW

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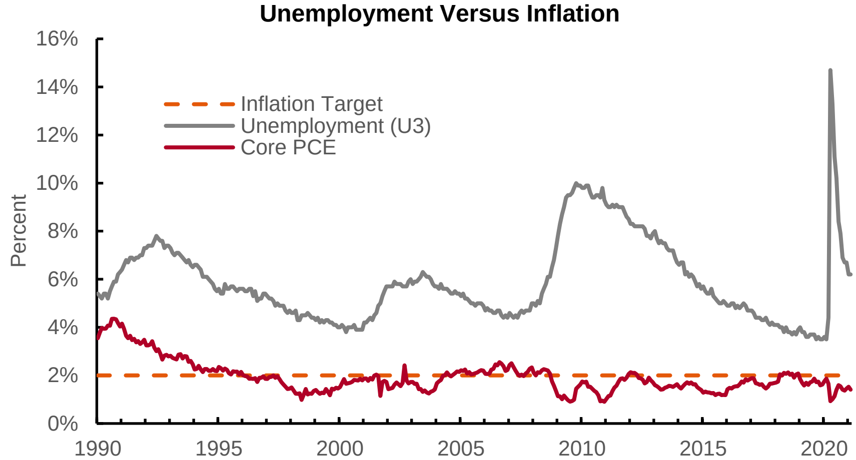
Birth of a New Approach: What to expect when you're expecting

The Federal Reserve has signaled a fundamental change in its approach to monetary policy, and the financial market trends we witnessed in the first quarter could be just a taste of what to expect longer term. To understand the change in monetary policy, let's first look back at what the Fed norms have been for the last few decades.

Lessons learned: Keep the inflation pot from boiling over

Having learned important lessons during the high inflationary period of the 1970-80s, the Federal Reserve until recently has taken a "pre-emptive approach" of targeting short term interest rates at a level that keeps inflation contained well before the economy overheats. To support this pre-emptive approach, the Fed has relied on the Phillips Curve model which indicates an inverse relationship between the unemployment rate and inflation. Using basic supply and demand curves, if there is ample supply of labor with high unemployment rates, then wages and general inflation levels are relatively low, and vice versa. In the 2000s, the Federal Reserve explicitly set a long-term inflation target of 2% and, with the Phillips curve in hand, set short-term rates where the trade-off between the unemployment rate and inflation intersects at 2%. In the past, the unemployment level needed to sustain a 2% long-term inflation target was about 5.5%. However, a combination of factors, including an aging workforce, global economic expansion, and efficient use of new technologies, has allowed the maximum non-inflationary unemployment rate to come down.

Unemployment Versus Inflation



To achieve the long-term 2% inflation target, the Fed would begin raising the short term Federal Funds rate during an economic expansion to slow economic

Key Points

- A reopening economy, coupled with massive fiscal and monetary support, and a consumer flush with cash will lead to a U.S. economic boom in 2021.
- The Federal Reserve's new average inflation targeting approach and broad and inclusive employment goals will keep monetary policy accommodative longer.
- The pandemic led to dramatic price swings for goods and services that are likely to reverse, though not reflective of true underlying inflation trends.
- Value, cyclicals, and international equities are expected to outperform in an above average economic growth and rising rate environment.
- Another fiscal infrastructure package, QE taper and tax increases are on the intermediate-term horizon.

Q1 Performance	
S&P 500	6.2%
Russell 2000	12.7%
Barclays Aggregate Bond	-3.4%
MSCI EAFE	3.5%
MSCI Emerging Markets	2.3%

growth, which would in turn slow the pace of the decline in the unemployment rate and keep inflation contained well before the economy had reached full employment. This pre-emptive, soft landing approach would give the economy enough runway to continue to expand without overheating, and inflation exceeding the 2% target. This approach allowed the Federal Reserve to ease off monetary accommodation during good economic times, rather than slam on the brakes quickly once sustainable higher inflation appeared.

The Results: Right strategy for the right time

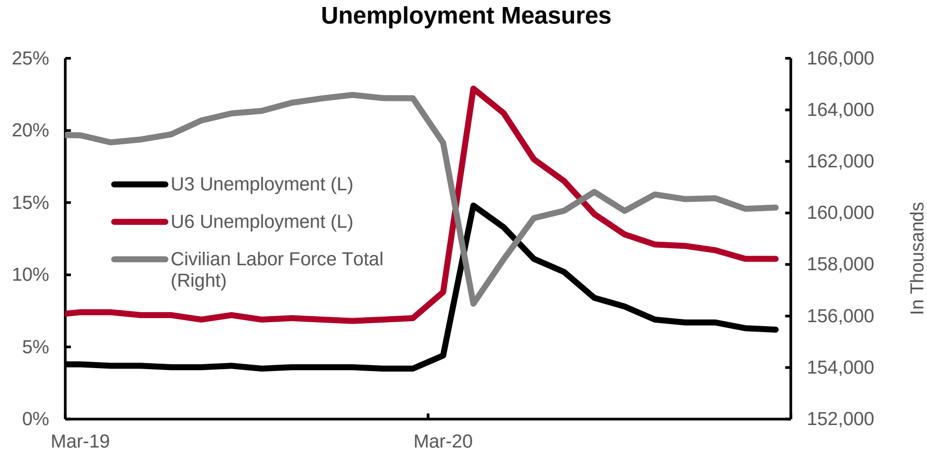
So, what have been the historical results of the Fed's pre-emptive approach? While this strategy has yielded both positive and negative economic and financial market consequences, in general it has led to lower overall inflation levels, lower interest rates, lower market volatility, and longer economic expansions. Unlike the 1950s through 1980s when the U.S. had to endure a recession every five years or so, the Fed's approach has supported long economic expansions with the last one being a record of more than 10 years, derailed by the start of the pandemic in March 2020. From a financial market perspective, the Fed's approach since 2009 has supported long duration investments (such as long maturity fixed income instruments and hyper growth sectors like technology), and investments that benefit from low volatility and low inflation (i.e. large cap, defensive, stable growers with low leverage). The Federal Reserve's recently announced monetary policy change to a new average inflation targeting approach leads me to believe that we will see a longer-lasting change in market leadership.

What's Changing? Take a broader view of unemployment and a longer view of inflation to let the economy bubble a bit before hiking rates.

We are still learning the full implications of the new approach, but back in August, the Fed revealed three conditions that had to be met before they would hike the Federal Funds rate from its current 0% to 0.25% target:

1) the economy reaches maximum sustainable employment,
2) inflation has risen to 2%, and
3) inflation is on track to moderately exceed 2% for some time.

Other than the 2% inflation threshold, there are a lot of questions about what unemployment level is meant by "maximum sustainable employment," and how high is "moderately above 2%" for inflation to rise before they arrive at their average 2% inflation rate over time. From Fed speeches this year, we have learned that the Fed is taking a very broad and inclusive view of the labor market for achieving its maximum employment goal. The Fed isn't just looking at the headline unemployment rate, which as of Feb. 28 was 6.2% for the number of people who are jobless but actively seeking work (the U-3 rate). They have been putting more emphasis on broader measures of unemployment, such as on the U-6 rate, currently at 11.1%, which includes discouraged workers who are no longer seeking jobs and part-time workers seeking full-time employment. The Fed also has emphasized the slack in the labor market by repeatedly pointing out the headline unemployment rate doesn't include the nearly 4 million people who have left the labor force since the pandemic started last year. What's also new is the Fed's emphasis on an inclusive look at racial differences in unemployment rates amongst whites, blacks, and Hispanics. Bottom line – the message from the Fed speak on unemployment is that they are a long way off from even thinking about hiking rates.



On the inflation thresholds, the Fed sent some signals with the release of their updated growth projections in March. Their outlook, as well as ours, is optimistic for an economic boom later this year given multiple factors:

1) The recent passage of President Joe Biden's $1.9 trillion American Rescue fiscal package (roughly 8.5% of GDP) on top of the $900 billion package passed in December;
2) Wide spread vaccine distribution coupled with full economic reopening, and
3) Pent-up demand from U.S. consumers who have accumulated trillions in excess savings.

The Federal Reserve has issued economic growth projections of 6.5%, 3.3%, and 2.2% for 2021, 2022, and 2023, respectively. Just as important, the Fed's median forecasts for inflation show a rise to 2.4% this year, then falling back to 2% in 2022 before rising a little to 2.1% in 2023 with an unemployment rate falling to a very low 3.5% rate. And, most important for the financial markets, despite projections for big economic growth numbers, much lower headline unemployment rates and higher inflation levels, the FOMC is guiding towards no rate hikes through the end of 2023. This is a big change from their prior pre-emptive approach. During past economic downturns, the Fed has been able to cut the Fed Funds rate 400-500 bps on average to provide monetary accommodation. Coming into the pandemic in early 2020, the Fed was only able to cut rates by 150 bps before hitting the zero lower bound, and they had to supplement with trillions in quantitative easing bond purchases. Now they are essentially easing into growth by keeping the funds rate at 0% while the economy booms and inflation trends higher.

What will it take to trigger a rate hike? Actual, not projected, inflation.

Fed Chairman Powell has stated, in effect, that he wants to see actual data rather than just a forecast at this point. My interpretation of this point is it's a complete 180-degree shift from their prior pre-emptive approach. Given that the Fed has had difficulty obtaining and sustaining their 2% core inflation goal over the past 20 years, they purposely want to stay *behind* the curve on inflation. Rather than get ahead of the inflation curve, the Fed wants to see the whites of the eyes of higher inflation before raising short term rates.

How has the market reacted to Fed's policy shift?

Stocks are up with the S&P 500 Index returning 6.17%, and bonds are down with the Bloomberg Barclays Aggregate Bond Index returning -3.37% for the first quarter. The bond market definitely got the wake-up call during this first quarter that there is a pro-cyclical shift at the Fed on top of the reinflationary pressures from the eventual complete reopening of the economy as a result of the vaccines. Ten-year U.S. Treasury yields nearly doubled from 0.91% at the start of the year to 1.74% by the end of the first quarter. Based on inflation break-even levels implied by current market rates, the bond market is now pricing in CPI inflation to average 2.6% over the next 5 years, the highest level for inflation expectations that we have seen since oil hit $140/barrel back in 2008. With nominal yield curves steepening, short-term rates pegged near 0%, and a Fed sitting on their hands, a lot of expected inflation is getting built into the market. You can also see it on the equity side with the energy sector being the best performer year-to-date alongside financials that are supported by steeper curves and higher rates versus the large cap growth equity style index which is flat for the year after being up nearly 40% last year and one of the best performing asset classes for the past 10 years.

What's the outlook for investors?

In the short term, we will always see ebbs and flows with what part of the financial market is performing best, so it's important to remain diversified across the major asset classes and within styles, cap sizes, and sectors. With the change in the Federal Reserve's approach, it does influence our framework as far as what types of investments we want to emphasize over longer investment time periods. Given the Fed's new approach, we are likely to see higher long term rates, steeper curves, higher inflation, and more volatility as the Fed gets further behind the curve on inflation and the markets continue to debate how committed the Fed is to this new approach. In that environment, the value style, small cap, long/short equity, non-dollar denominated investments, and commodities would perform relatively better than what has worked over the past decade.

What else can we expect on the economic front over the next year?

Looking out shorter term over the next year, we are expecting Biden to follow up with another $3 trillion+ fiscal package proposal that focuses on infrastructure and clean energy investments. Based on his campaign proposals, I suspect the package will be funded partially with higher taxes on upper income wage earners and corporations. Unlike the quickly passed COVID-relief packages, congressional debates on the size of the infrastructure package and how it's paid for probably will go on throughout the summer. It's probably not all going to be paid for with higher taxes and will likely add to more downward pressure on the U.S. dollar. Secondly, if the much stronger economic growth numbers for 2021 are realized, our investment management group is already to starting to think about how the Fed might eventually set the markets up for a tapering of its asset purchase program, aka "quantitative easing," or QE. The Fed has stated that it wants to see real progress towards its inflation and employment goals before it starts a QE taper. Given the Fed's forecast of 4.5% unemployment by the end of 2021, they could start setting the market up for the taper very late this year or in early 2022 with a long lead time before they actually start to slow down monthly bond purchases. Finally, the U.S. is now ahead of schedule with its vaccine rollout, and Biden has stated that there will be sufficient vaccine supply for all U.S. adults by May. The full reopening of the U.S. economy is now more likely to happen in the 2nd quarter with big gains in employment, as the leisure and hospitality sector accounts for nearly a third of the remaining jobs lost since the pandemic. The path of least resistance for long term interest rates in a full reopening is still higher. While certain sectors of the equity market have had trouble digesting the speed of the recent rise in long term interest rates, much better GDP growth over the next couple of years means better earnings per share growth which likely will support higher stock prices.

Disclosures

Chart data source: Bloomberg