Fed comments feed long-term investor dovishness

- **Investors are assessing the possibility of a new Fed policy framework**
- **Recent Fed speakers emphasise the risk that inflation drifts below the 2% target …**
- **… and suggest that policy would shift to some form of price level targeting from inflation targeting**
- **The balance sheet is likely to stop shrinking in H2**
- **The Fed, at some point, will buy Treasuries to offset MBS sales**

The Fed is worried about the zero bound

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We think the investor takeaway from Fed comments at a conference on 22 February will be dovish. The dovish themes: (1) explicit concerns that inflation will average below the 2% target because of the zero bound, and (2) Fed Vice-Chair Clarida's focus on a price level target for monetary policy. He did not endorse any outcome but his emphasis suggested that he might be leaning to (possibly modified) price level targeting. Fed funds, 2Y and 10Y yields moved down despite inflation expectations edging higher[1] (see *SMS – So far so good* for our read on inflation and yields).

This note focusses on how investors will integrate these potential Fed moves into medium-term asset price expectations. We suspect the impact on inflation and inflation expectations will be less than expected and the main takeaway will be that the Fed will keep struggling to hit inflation goals. In particular, we think the Fed will have a hard time convincing the market that it will do what it takes to hit inflation targets. In the meantime, the starting point of low inflation and accumulative shortfall versus inflation targets in recent years will make the dominant theme the easing bias.

These discussions are in the context of future policy responses to cyclical downturns. However, given the cumulative shortfall in this cycle and the expressed concerns that inflation expectations may be falling, it seems likely that investors will see these concerns as informally guiding policy in the current cycle.

The downward move in long-term real and nominal yields is likely to be USD bearish unless other central banks use this as their cue to take similar walks on the dovish side or their negative activity and inflation shocks are more acute than in the US. Year to date, 10Y yields have come off less in the US than in other G10 economies, other than Italy (Figure 1). The USD may be supported in the short term if US equities respond more than abroad and US recession risk unwinds. The USD was a safe haven over the last year, so broadly speaking the Fed's new-found friendliness should be USD negative.

[1] The potential hawkish twist was the discussion of reducing the duration of Fed Treasury holdings. The most likely outcome is that Fed Treasury holdings will match Treasury supply in terms of tenor, There is discussion that the Fed might shift to a bills-only portfolio that would require a lot more selling of long-term Treasuries and buying of bills, but that seems less likely. Mitigating the impact on Treasury yields is that the Fed intends to run down MBS (mortgage-backed securities) holdings, so at some point they are likely to be buying Treasuries to offset these sales.

Making up lost inflation – will investors buy in?

Why price level targeting?

Federal Reserve Bank of New York President Williams and Fed Vice-Chair Clarida both conveyed to investors that the Fed was more concerned about inflation undershoots than overshoots. Clarida discussed the Fed's upcoming re-evaluation of its targeting mechanism, and spent a fair amount of his speech on mechanisms to make up for inflation shortfalls via price level targeting. There are alternatives – nominal GDP targeting, negative rates, modern monetary theory (MMT), more aggressive asset purchases – but investors will reckon that Clarida would not have spent so much time on price level targeting if it was not a (maybe the) front-runner.

The strictest form of *inflation* targeting says that the central bank is only interested in hitting its inflation target. Misses are written off. *Price level* targeting in its strictest form forces you to make up for past shortfalls or excesses. So a period of inflation undershooting would mean the central bank has to exceed the target for a period of time and vice versa.

In theory and based on modelling exercises, price level targeting should get you closer to inflation averaging at its target than inflation targeting. An additional advantage is that if you hit the zero bound (and it doesn't look like the Fed sees negative rates as a serious option), the market will build in an expectation of higher inflation down the road to make up the shortfall, so rebounds should be faster. If the target is more aggressive, so will be expectations.

Bottom line – if everything works, then price level targeting works better.

What will investors worry about?

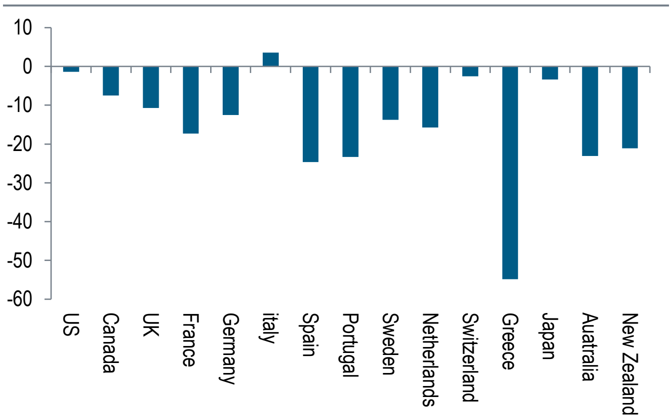
1. If they could have generated more inflation they would have

If we use 2007 as the base for a price level with a 2% growth path, realised core PCE has undershot by 4.6% through 2018 (Figure 2). For much of that period, inflation was visibly undershooting, the Fed was aggressively trying to hit the target and it still missed. If it was the ECB and it was targeting 1.8% inflation on CPI ex food, energy, alcohol and tobacco, the shortfall would be 7.8%.

For price level targeting to be credible, investors have to believe that they will run the economy hot enough for long enough to make up the inflation shortfall. However, if it looks as if the Fed's tools to hit less aggressive inflation targets are weak, there may be scepticism about the ability to hit more aggressive targets.

Figure 1: YTD changes in 10Y bond yields

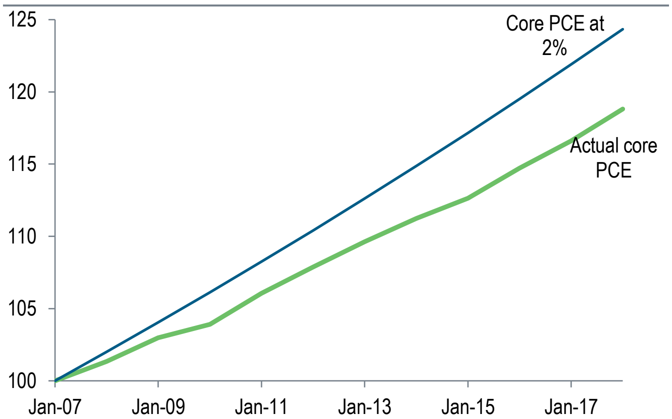
Bps



Source: Macrobond, Standard Chartered Research

Figure 2: Actual core PCE and 2% inflation level

Index, 2007=100



Note: The 2% inflation level is obtained by indexing the 2007 level to 100 and assuming 2% annual inflation. Source: Macrobond, Standard Chartered Research

The juice from the shift to price level targeting is that investors believe that rates will be lower for longer and adjust their inflation expectations upward. If it turns out that inflation is driven by structural and technological forces, and is unresponsive to monetary policy, the plan to close the gap between realised and targeted levels will not have much credibility.

In the US, 5Y5Y inflation breakevens averaged 2.7% between 2010 and September 2014 until the oil price collapse dragged inflation expectations lower. While that is not rollicking inflation when converted to PCE equivalents (maybe 2.3%), you can debate whether the failure of inflation to pick up was because inflation expectations were inadequate or because of the strength of disinflationary forces.

Looking at the ECB, they would have to be running at 2.5% a year for the next 10 years to get back to their target. The ECB might argue that its commitment would be enough to shift expectations higher. We would question whether investors would believe them, given past failures.

2. Political forces may oppose

Investors will also question whether political forces would permit the kind of easy money for extended periods that they are promising. The Fed saw the wealth effect as an additional piece of stimulus. We doubt that they intended to alter income distribution or expected the asset price effects to be so much stronger than the output and inflation effects. We suspect there may be some political criticism of policy that looks as if it will again reward older property owners versus young renters and owners of financial assets versus workers.

3. Asset market ebullience

If the promise of low rates for an extended period raises risk appetite, investors will expect the liquidity provision to stop. The models that we have seen do not have an asset price constraint (however defined). In the real world, investors will expect both an asset market response (as we have seen in recent days) and a Fed response to the asset market response. The ability to catch up on inflation misses may be limited by the central bank’s unwillingness to tolerate excess risk taking.

4. … And if it works too well

From an investor viewpoint, the nice property of an inflation target is that models by and large tell you to give lots of stimulus when far from inflation and unemployment targets and reign it back gradually to have a smooth glide path to neutral. In the best of all worlds, inflation is never expected to overshoot or undershoot.

Price level targeting depends much more on the model being right. Getting to the price level target means running the economy ‘hot’ for a period, then generating a slump to slow inflation from above target to just on target when it gets back to the price level target. Hitting inflation targets is hard enough for central banks. Gauging how much overshoot of inflation is required for how long and the right amount of restraint when the price level target is in sight is even harder.

When the price level is below the targeted path it is easy to run hot. Will it be that easy to run cool when the price level is above target? It is not a problem that appears imminent, but our conjecture is that few central banks would push an economy into recession for the sake of a price level target. It is more likely that they say ‘bygones are bygones’ on an overshoot and ‘we have to make it up’ on an undershoot.

Temporary price level targeting

Former Fed Chair Bernanke has recognised that it is impractical to sink the economy on an inflation overshoot. He has proposed what he calls temporary price level targeting. The idea is that the Fed follows a normal inflation targeting procedure until Fed funds hits zero. When it hits zero, the Fed commits to keeping monetary policy easy until inflation makes up any shortfall from 2% that occurs because of the zero-rate constraint. Such temporary price level targeting would require deft communications skills and would promise aggressive policies during severe downturns without unrealistic tightening during inflation overshoots. Some form of this approach may come to be viewed by investors as the most likely outcome.

What wasn't discussed – Modern Monetary Theory

Modern Monetary Theory (MMT) is a challenge to Fed's conventional monetary framework from the progressive side, although MMT itself developed well before the political winds shifted in 2016. It combines two progressive priorities – higher government spending and higher taxes. The idea is that macro policy has three policy tools – the level of government spending, the level of taxes and the interest rate, but stresses the fiscal side over the monetary side. It is not mainstream yet, but investors should be aware of the implications if there is a major shift left in 2020.

MMT sees the basic goal of policy to achieve full employment. Spending, and if needed taxes, are better ways of achieving this goal than conventional monetary policy. If spending overheats the economy, policy makers can raise taxes or interest rates. The key insight is that government spending in a closed economy can always be financed by the central bank. Inflation targets can be hit by means of taxes or policy rates, and full employment can be achieved more quickly. The role of monetary policy appears to be secondary, financing government deficits until inflation becomes a worry.

MMT is controversial but it 'solves' a set of problems that conventional monetary policy has had trouble dealing with. First, its advocates argue that output goals are likely to be reached because spending is a direct driver, not monetary policy, and spending is effective. Not spoken but in the background, it doesn't rely on the wealth effect for stimulus and the spending is for employment and infrastructure, so the impact on wealth distribution is thought to be favourable. The possibility of raising taxes is explicit, which has a lot of appeal on the progressive side.

Critics argue that fiscal policy is not as flexible as would be needed and that the heavy intervention of the government would mean that incentives are distorted and resources misallocated. However, it is very appealing for those who think a far more fundamental monetary policy revamp is needed.

This is not a major investor concern yet, but would likely look more interesting in case of a large negative shock that conventional monetary policy could not deal with. Proponents see it as a way of achieving long-term policy goals, in other words as a long-term structural shift in how policy is conducted.

Our conjecture is that some form may be implemented cyclically if conventional monetary policy is inadequate to revive the economy quickly enough. While proponents see it as the everyday framework for monetary policy, the compromise might be that it is okay to use when there is a cyclical shortfall in demand and inflation that conventional monetary policy cannot address, and is set aside during normal times, when risk of microeconomic distortions loom large.

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Document is released at
13:08 GMT 25 February 2019