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The Markets & the Economy - What We're Watching

Top Pick of the Week:

- Fed Chairman, Jerome Powell announces Thursday a tolerance for higher inflation

The Federal Reserve announced Thursday a significant policy shift, confirming it is willing to have inflation run above its goal of 2% "for some time". This shift is partially in response to trying to achieve a more stable inflation rate - achieve maximum employment and price stability. In order to get ahead of the traditional correlation between low unemployment and high levels of inflation, they are preemptively asserting this necessary shift. While it may seem contrary to the norm that the Fed would want higher inflation, it is also true that inflation that is too low for a long time can be damaging to an economy as well. As Powell explained "[extended periods of low inflation] can lead to an unwelcome fall in longer-term inflation expectations, which, in turn, can pull actual inflation even lower, resulting in an adverse cycle of ever-lower inflation and inflation expectations."[1] If expectations become too low and remain there, it may not allow the economy to push upward, but rather spiral downward. By increasing expectations, it allows rates to move higher toward their neutral rate and have latitude to move in either direction, to either stimulate growth or dampen an overheated economy. We need to also be mindful to allow enough run that we get expectations to a point where we can return rates to neutral and not do so in a way that dampens expectations before they get high enough to be sustained. This has happened in other economies across the globe, the Fed knows this and wants to adjust the policy framework to prevent any negative ramifications.

Back in the early 2000's, many central banks adopted an inflation targeting goal thereby raising the importance of its price stability goal relative to full employment. Doing so created an increased level of transparency of the central banks intentions and as such, the markets had a more defined target to hit. Initially upon Chairman Powell's statement yesterday the market didn't have a significant reaction to the news, but futures later moved higher.

To reach their decision, the Fed conducted a series of forums as part of their *Fed Listens* events program with a wide array of participants – unions, small business owners, low income communities, retirees, etc. – to better understand how economic policies affect people's daily lives. Additional contributing factors that lead to the Fed's review and ultimate policy shift include the following:

1. **Assessments of the potential, or longer-run, growth rate of the economy have declined**. This is believed to be due to a slowing population growth and more recently, a decline in productivity growth (lower output per worker).
2. **The general level of interest rates has fallen both here in the United States and around the world**. The expectations for growth have fallen along with lowered "neutral" interest rate expectations falling from 4.25% to 2.5%. This is considered the rate at which an economy can maintain rates and stay strong. This is effectively keeping rates lower even in good times as we saw in the most recent expansion.

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[1] CNBC

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3. **The record-long expansion that ended earlier this year, led to the best labor market we have seen in some time**. The historically low unemployment period pre-covid reached deeper into the economy than any other period for the labor market. It offered more opportunity for workers and increased the overall capacity of our economy as we expanded the workforce beyond historical levels.
4. **The historically strong labor market did not trigger a significant rise in inflation**. This has typically been the concern for full employment. As the population of available workers becomes scarce, it creates wage growth that stokes inflation. However, this time despite the long period of full employment we just experienced, the forecasts for a return to 2% inflation were rarely realized and never sustained. The Phillips Curve illustrates the idea that inflation and unemployment have an inverse relationship – as one rises the other goes down. However, recently it was flat. This flattening has led to a lower overall expectation for inflation and has made the ability to reach the inflation goals much harder both domestically and internationally.

Fed Chairman Powell in his statement maintained the practice of not providing a numerical goal for employment, but rather stated they maintain a longer run inflation target of 2%, and that policy must be forward looking and account for expectations. The Fed emphasized its commitment to strengthening the labor market and disconnected the notion that a strong job market will necessarily stoke inflation. One of the most noteworthy statements in the new policy may have been that the Fed will now seek to achieve inflation that *averages* 2% over time. This change effectively breaks the cycle we have been in with inflation consistently running below 2%. For example, up until now whenever we got close to reaching the 2% rate, the Fed would start to raise rates, this plan gives them more flexibility where they don't have to raise rates until it's over 2%. By seeking to average 2% as opposed to having it as a target, it allows the Fed room to have inflation run over the target for periods to achieve the average as a goal.

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Commentary is reflective as of the close Thursday, August 27, 2020.

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