



CHIEF INVESTMENT QUARTERLY

Fed Policy Plays Catch-Up

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In the first quarter of 2019, the Fed delivered some dramatic news by shifting its policy guidance, with significant ripple effects across global markets. In many ways, though, policymakers were catching up with fundamental trends that have been apparent for some time. In fact, Jerome Powell's Fed might finally be acknowledging a change in the economy that is already decades old.

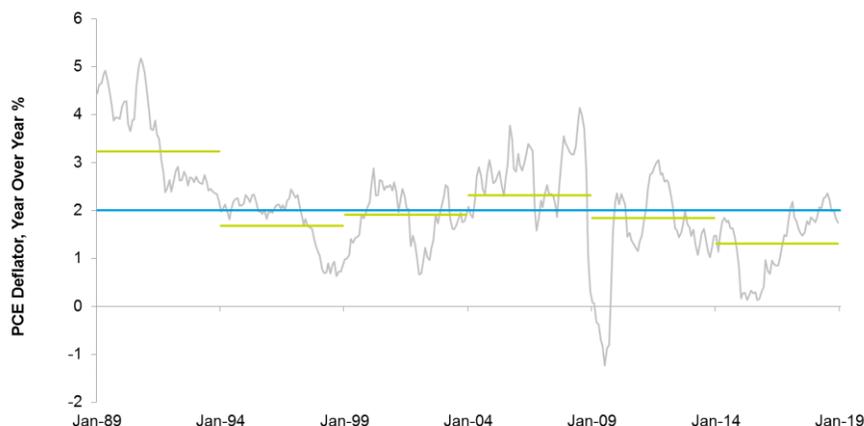
As late as December 2018, the Federal Open Market Committee (FOMC) voted unanimously for their fourth rate hike¹ in a year and projected still more for 2019. Markets received this poorly, with equities extending losses and credit spreads widening.² The Fed seemed to be focused too narrowly on strong domestic data, while underreacting to signs that the global economy was losing momentum. The committee's devotion to rate hikes seemed out-of-date.

Since the start of the year, however, Chair Powell has done a drastic about-face, much to the relief of financial markets. Appearing with former Chairs Bernanke and Yellen on January 4th, Powell was more dovish, stating that "there is no preset path for policy" and "we will be patient as we watch to see how the economy evolves."³ By the March FOMC meeting, policy had finally caught up with the negative news of late 2018. Officials voted unanimously to leave rates on hold, and most meeting participants forecast no additional hikes for the remainder of the year.⁴ The shift in tone from the Fed had a powerful impact on markets, helping global equities and credit to one of their best quarters in recent memory despite still-unresolved concerns about the global economy.⁵

Done Fighting the Last War?

Intriguingly, the Fed's change in short-term guidance was also accompanied by talk of a larger rethink in long-term strategy. The Fed has committed to an inflation target of 2%,⁶ and in theory wants readings to be symmetrical around that goal.⁷ But in

Inflation Averaged below 2% in 4 of the Last 5 Half-Decade Periods



Source: AQR, Bureau of Economic Analysis. The 2% inflation target was formally adopted in 2012. Data presented ranges from January 31, 1989 to January 31, 2019.

practice, inflation has been consistently below target for a long time. The average over the five years through December 2018 was only 1.3%, and in fact, if we break up the past few decades into five year windows, four of the last five have been sub-2%.⁸

Nevertheless, the Fed has continued to behave as if an inflationary surge is right around the corner, tightening policy preemptively whenever the economy is strong. Notably, this fear of high inflation seems to have been priced out of markets long ago. TIPS breakevens, for example, have been pricing long term inflation below the Fed's target for years.⁹

With this in mind, in February, Vice Chair Clarida and New York Fed President Williams began to argue for a new approach that targets an average inflation rate of 2%, and seeks to make up for below-target periods with matching periods of above-target inflation. At last, officials appeared to be catching up with evidence that has been building up in the data and markets for a long time, namely that the hard-fought war against inflation has been over for decades, and the Fed won.

Short-Run Challenges

It may be premature for investors to assume a new inflationary regime in Fed policy. Technically, the concept of average inflation rate targeting has merely been put forward as one topic in a year-long broader review of Fed strategy. So beyond changes in Fed policy, what can we say about the outlook for returns in the short-run?

After a quarter in which all traditional asset classes delivered strong gains,¹⁰ investors may face a more challenging environment in the remainder of the year. As we have noted in the past,¹¹ valuations for both stocks and bonds remain demanding and investors should temper their long-run return expectations accordingly. In the near-term, fundamental trends for both stocks and bonds are not overly helpful either. Improved risk sentiment and lower bond yields are positive for equities, but important headwinds persist, including negative growth trends and the lagged impact of past monetary tightening. A more enthusiastic view on stocks would likely require some combination of improved growth and reduced political uncertainty.

In contrast, bond investors may be hoping for continued bad news on the growth front, as fears of a global downturn have pushed yields to multi-year lows. Fixed income markets look vulnerable if growth data stabilizes or risk sentiment continues to improve.

Long-run Implications

Should the Fed truly embrace the new approach discussed in recent months, there could be major implications for markets. Pushing inflation above target to make up for past shortfalls might require low rates for the foreseeable future. A reduced threat of a policy-induced downturn could benefit risky assets such as equities and credit. Loose policy could also be supportive for short-dated Treasuries, while longer-dated bonds might suffer if markets price in higher long-run inflation. Commodities should benefit from stronger growth expectations, and would receive an additional boost if investors increase allocations to inflation-sensitive assets.

Actual market behavior in the first quarter suggests investors may only partially believe this story. Short-dated bond yields moved to price greater odds of rate cuts than rate hikes, indicating market participants took the Fed's dovish tone seriously. However, long-dated yields fell even more,¹² giving little indication that investors expected higher inflation. In fact, the U.S. yield curve¹³ inverted late in the first quarter, a development typically associated with tight policy and recession risk rather than loose policy and inflation risk. Commodity returns were mixed, with strong gains in growth-sensitive assets such as crude and copper, but lackluster changes in traditional inflation hedges such as gold and silver.¹⁴ Investors seemed to believe that policy would be loose and that this would support growth, but remained skeptical that this would impact inflation in the long run.

A capable and strong-willed Fed defeated a strong foe in the sustained inflation of the '70s and '80s. Perhaps investors shouldn't be too skeptical of its ability to meet the challenge of re-inflation, a challenge many inept central bankers have overcome in the past without even trying.

[1] Federal Reserve Press Release; "Federal Reserve issues FOMC statement" 12/19/2018.

[2] Proxies used for equities and credit are the S&P 500 and Markit CDXNorth America Investment Grade index. The time period referenced is from December 19, 2018 to December 24, 2018.

[3] CNBC: "Powell says Fed 'will be patient' with monetary policy as it watches how economy performs," 1/4/19.

[4] Federal Reserve Summary of Economic Projections, 3/20/19.

[5] Data remained downbeat, particularly in Europe and China, and there were signs that the U.S. economy had decelerated as well. Trade tensions between the U.S. and China were reduced, but lingered as the two sides agreed to a "truce" while negotiations took place. Continued uncertainty over Brexit cast a shadow over the European outlook.

[6] Federal Reserve goals as indicated by the "Statement on Longer-Run Goals and Monetary Policy Strategy," adopted effective January 24, 2012.

[7] The Fed uses the PCE Deflator as its preferred measure of inflation.

[8] AQR, Bureau of Economic Analysis (BEA).

[9] Bloomberg. TIPS are linked to CPI inflation, which has averaged about 0.3% higher than PCE inflation over the last twenty years, meaning that CPI inflation of around 2.3% would be consistent with the Fed's 2% PCE target. 10-year TIPS breakevens have not closed above 2.3% since the start of 2014.

[10] MSCI World, Global Agg, Bloomberg Commodity Index. Pricing from Bloomberg.

[11] AQR 2019 Capital Markets Assumptions Alternative Thinking Paper.

[12] Bloomberg. U.S. 2-year Treasury yields declined by 23bps in 1Q19, while 10-year yields declined by 28bps.

[13] Specifically, the slope between 3-month Treasury bill yields and 10-year Treasury note yields.

[14] Bloomberg. Front month futures prices for copper and WTI Crude rose 11.6% and 32.4% respectively, while gold rose 0.9% and silver fell.