

Fed to keep rates low despite rapid drop in unemployment

The Federal Reserve made only minor changes to its policy outlook, despite the recent run of better-than-expected economic data. Instead, the Fed has adjusted its approach to permit inflation to rise higher before it is compelled to raise interest rates.

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WHAT HAPPENED?

Despite significantly upgrading its outlook for the U.S. economy, the Federal Reserve's Open Market Committee (FOMC) remains committed to maintaining extraordinarily accommodative monetary policy in the coming years.

Since bottoming in April, the U.S. economy has recovered at a pace that has surprised financial markets and also, it seems, the Federal Reserve. The Fed's summary of economic projections, updated for the first time since June, contained large upward revisions to its growth and employment forecasts for 2020, with this year's projected GDP change revised up to -3.7% from -6.5%.

The U.S. unemployment rate, 8.4% as of August, had already dropped well below the Fed's 9.3% year-end forecast from back in June. The committee now projects a further decline to 7.6% by December and a return to "full" employment in 2023. Today's updated projections also included the so-called "dot plot" of members' expectations for interest rate

policy. Only one member expects rates to rise from their current near-zero level by 2022, and a large majority of members projects no change through 2023.

Taken together, the forecasts imply that rates will still be at zero even when full employment has been achieved and core inflation has returned to 2%. To understand why, consider the Fed's recently announced average inflation targeting policy, about which we say more below. The FOMC statement makes it clear that the Fed will now be encouraging inflation to move "moderately above" its 2% target "for some time" to offset the extended period during which it has been well below.

POWELL CALLS FOR MORE FISCAL HELP

Federal Reserve officials normally hesitate to call for specific Congressional actions to help the economy. Chairman Jerome Powell, however, has made it clear that the U.S. continues to face long-term risks from the aftermath of the coronavirus crisis and that more federal spending is needed – both today and in the future – to help return the labor market to its formerly robust state.

Starting on 31 July, benefits paid to recipients of unemployment insurance were cut by \$600 per week, thanks to the expiration of that provision of

the CARES Act. That means nearly 30 million Americans are no longer receiving emergency income support. While the U.S. economy may be strong enough to survive the resulting income cliff, an economic policy error – whether by the Fed or by Congress and the White House – is now the primary source of risk for a double-dip recession.

In addition to income support provisions for individuals, small business assistance through the Paycheck Protection Program is running out, as is aid to state and local governments, which are in the process of trying to reopen schools. The nationwide switch to online learning in many precincts threatens the labor market as more parents – especially mothers – drop out of the labor force to assist with homeschooling or online learning.

WHAT IS AVERAGE INFLATION TARGETING?

At the Fed's annual Jackson Hole summit in August, Powell unveiled a new inflation-targeting scheme. Since 2014, the Fed has had an explicit inflation target of 2%, measured by the change in the core personal consumption expenditure (PCE) price index. Moving forward, the Fed will be targeting that 2% rate "on average" rather than at a specific point in time.

How might this new approach alter Fed policy? For most of the past 20 years, inflation has run below 2%, thanks to a variety of factors ranging from severe economic crises to growth in e-commerce. While the definition of "average" inflation remains vague, the Fed committed today to trying to push core PCE inflation above 2% for an unspecified period of time.

The Fed has two main policy goals here. First, it wants to avoid unnecessarily slowing the economy with interest rate hikes, so it is effectively raising the bar for eventual policy tightening. Second, the Fed is acutely aware of the issue of income inequality. In recent cycles, workers in lower-skill jobs, women and people of color generally have seen their employment prospects and wages improve only at later, hotter stages of the cycle. By encouraging inflation to run higher and allowing cycles to run

longer, the Fed is making reduced income inequality an unstated policy goal.

NUVEEN'S OUTLOOK

The parts of the U.S. economy that can function in an ongoing pandemic are doing so. The cornerstones of this recovery include housing, technology, manufacturing and consumer spending on goods, while spending on services like travel and leisure remains understandably depressed. The virus has effectively capped the pace at which the economy can grow from here, as entire industries remain closed or well below their operating capacities. Third quarter GDP growth is tracking north of 30%, annualized, but Q4 will almost certainly see a major deceleration.

As we wait for good news on a vaccine, significant increases in inflation or longer-term interest rates are not yet imminent concerns. Therefore, we see little scope for major changes in the Fed's monetary policy approach for a year or two, and perhaps beyond.

INVESTMENT IMPLICATIONS

If the Fed can actually engineer higher inflation (given its track record of late, that's a big "if") it could benefit assets that provide real income returns like TIPS or real estate. More broadly, asset classes that are helped by low rates and the resulting search for yield, like emerging markets debt or U.S. high yield credit, should be well-supported.

Income-sensitive investors should already be looking for ways to augment their current portfolio with assets that offer a combination of higher yields, inflation protection and diversification. When the 10-year U.S. Treasury note yields less than 0.75%, a core bond portfolio is unlikely to provide adequate returns on its own. A combination of higher-yielding fixed income, real assets and income-focused equities can help.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Federal Reserve Statement, September 2020.

Bloomberg, L.P.

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Glossary

A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

The **Federal Open Market Committee (FOMC)** holds eight regularly scheduled meetings per year to review economic and financial conditions, determine the appropriate stance of monetary policy and assess the risks to its long-run goals of price stability and sustainable economic growth.

The **personal consumption expenditure price index (PCEPI)** is one measure of U.S. inflation, tracking the change in prices of goods and services purchased by consumers throughout the economy. Of all the measures of consumer price inflation, the PCEPI includes the broadest set of goods and services. Core PCE excludes food and energy prices.

A word on risk

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