

Flexible Average Inflation Targeting: FAIT and the Fate of Investor Allocations

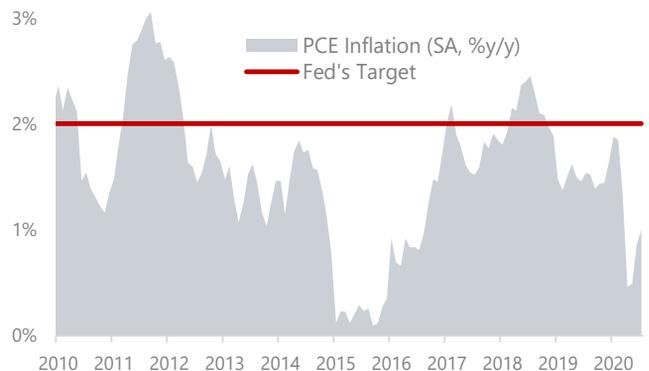
At the annual Jackson Hole economic policy symposium in August 2020, the Federal Reserve made important changes to its Statement on Long-Run Goals & Monetary Policy Strategy, all of which were consistent with a higher bar for removing policy accommodation than in previous cycles and low rates for longer. First, the Fed indicated that it will no longer raise rates preemptively on the basis of low unemployment rates alone, having learned that it cannot estimate “maximum employment” with any certainty. Progress on realized inflation will instead become the primary guide for removing policy accommodation. Equally importantly, the Fed formally adopted a flexible average inflation targeting framework (“FAIT”), which seeks to achieve inflation that averages 2% over time and will allow inflation to overshoot after a period of undershooting, more firmly anchoring inflation at the 2% objective. In this piece, we consider the implications of the Fed’s new framework for investor allocations.

WHAT IS FAIT AND HOW IS IT ANY DIFFERENT?

In practice, FAIT should result in much different policy than in past hiking cycles. For example, looking back to the Fed’s first rate hike in 2015, core inflation was at 1.3%, well short of the 2% target, but the unemployment rate had slipped below their estimate of maximum employment, triggering preemptive policy tightening under the Phillips Curve framework. Under its new FAIT framework, the Fed would not have viewed the very low unemployment rate as a trigger for policy action; instead, the Fed is viewing its maximum employment objective asymmetrically, and will provide accommodation to address “shortfalls” from maximum employment, but will not respond to very low unemployment rates with tighter policy. Looking back to the 2015 example, the Fed would not have viewed the unemployment rate as a trigger for policy action and would have instead allowed the unemployment rate to continue drifting lower as it sought an inflation overshoot. As such, it could have taken several more years at the effective lower bound before the Fed determined it was time to remove policy accommodation. In an alternate scenario, however, where core inflation started to move above the target, but unemployment remained above the Fed’s assessment of maximum employment, the Fed would have also maintained accommodative policy for longer, as their desire to see an inflation overshoot after a period of undershooting would have complemented their maximum employment objective.

Figure 1: Actual Inflation Mostly below Fed Target

PCE Inflation vs Fed Target Inflation, Last 10 years ended July 2020



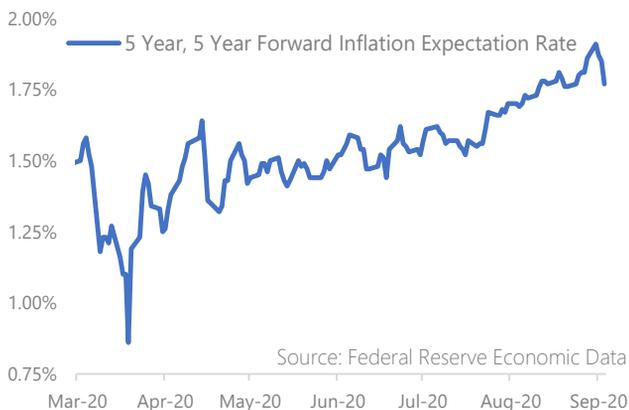
Source: Bureau of Economic Analysis

RISING INFLATION AND FALLING REAL YIELDS

If the Fed successfully generates above-target inflation and continues to pin rates at the effective lower bound, long-term nominal yields should start to increase while real yields decline. Recently, rising inflation expectations (see Figure 2) in an environment of stable long-term nominal yields has resulted in decreasing real rates of returns on bonds (see Figure 3).

Figure 2: Rising Inflation Expectations

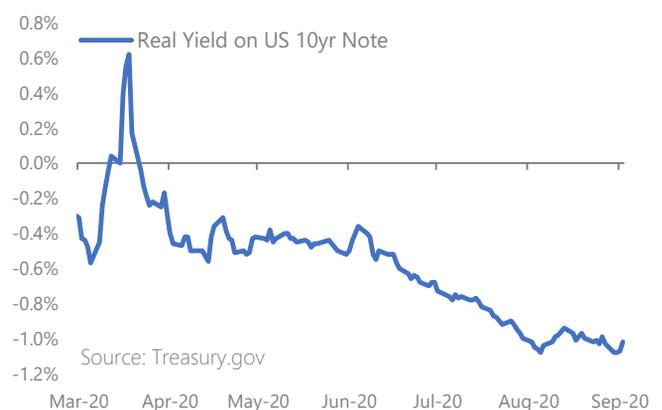
Since COVID-19 Crisis, March 1, 2020 through September 3, 2020



Source: Federal Reserve Economic Data

Figure 3: Falling Real Yields

Since COVID-19 Crisis, March 1, 2020 through September 3, 2020



Source: Treasury.gov

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TIME TO GET REAL WITH YIELDS: IMPLICATIONS FOR INVESTOR ALLOCATIONS

Fixed income has historically been a staple allocation within a traditional portfolio, and given the fixed income bull run over the last few decades, this allocation has paid off. However, the Fed's shift toward FAIT has real implications for investor allocations: with interest rates set to remain low for the foreseeable future and inflation expectations theoretically on the rise, the value of holding bonds inevitably depreciates. While an increase in equilibrium real interest rates could theoretically provide some offset, equilibrium rates are driven by long-term structural forces that monetary policy does not have the power to influence and appear unlikely to change in the near-term. Indeed, as Powell explained at Jackson Hole, the neutral rate of interest "is not affected by monetary policy but instead is driven by fundamental factors in the economy, including demographics and productivity growth—the same factors that drive potential economic growth."

Using simple bond mathematics, Figure 4 shows the historical yield on the U.S. 10 year note alongside the returns realized over the subsequent 10 years from holding the note to maturity, including reinvestment of coupon payments. The 0.65% yield as of August 2020 provides a strong estimate of future bond returns, and if interest rates fall from here, this will result in a holding period return below 0.65%. Looking ahead, if fixed income is less capable of delivering material returns, it will be important to have allocations to strategies that can. As investors re-evaluate the role of fixed income in their portfolios, strategies that have the potential to deliver meaningful returns with low correlation to equity markets will be invaluable.

Figure 4: Bleak Return Outlook for Bonds

January 1900 through August 2020



Based on 120 years of data, there is an 85% correlation between the 10yr Treasury yield and returns over the next 10 years. Figure 4 shows the yield on the U.S. 10yr note and the return an investor would realize over the subsequent decade when held to maturity, including the reinvestment of coupons.

Data Source: Robert Shiller Database, 10yr Treasury Constant Maturity Rate (GS10)

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THE BOTTOM LINE

- The Fed's new FAIT framework provides forward guidance for a prolonged period of low rates.
- Real yields are expected to decrease while inflation is expected to increase.
- A heavy allocation to fixed income may prove unfavorable to overall portfolio returns.
- Investors should consider other diversifying strategies that have the potential to deliver material returns and equity downside protection.

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