# The Fed Signals Inflation Rethink

## Addressing the Complexity of Price Stability

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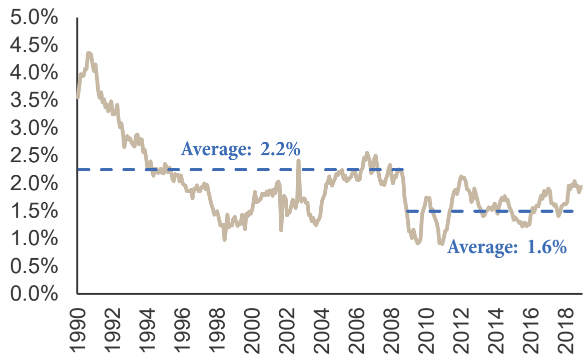
### Introduction

At its January 2019 meeting, the Federal Open Market Committee (FOMC) announced that it was pausing its interest rate increases and would raise the federal funds rate further only if the economic data warranted it. This change in stance came on the heels of mixed economic data and volatile capital markets in the fourth quarter of 2018. In addition, the statement noted that while inflation remains near the Federal Reserve's (Fed's) 2% target, some market-based measures of inflation had moved lower. The statement issued after the March meeting further noted that inflation over the past 12 months had declined. Indeed, the Fed's preferred measure of inflation, core Personal Consumption Expenditures (PCE) price index, has consistently undershot 2% since the economy emerged from the financial crisis and has averaged 1.6% since 2009 versus 2.2% from 1990 to 2007 (see chart below).

**U.S. Core PCE Price Index**




Source: Bloomberg

As a result of this prolonged period of muted inflation, the Fed has undertaken a project to study whether it should change its inflation targeting framework and allow inflation to run above 2% for a period of time to offset periods of lower inflation.

As an instrumentality of Congress, the Fed has been given two objectives: maximum sustainable employment and stable prices. The Fed, along with other major central banks, has operationalized stable prices as inflation of 2%. Why has the Fed decided on 2% as the definition of stable prices? Why not target inflation of 0%? If inflation is running below 2%, why does the Fed care? What is the rationale for allowing inflation to exceed 2% to offset periods of less than 2%? And what implications does this have for investing institutional portfolios?

### The Federal Reserve's Mandates and Its Inflation Target of 2%

During a Fed meeting in 1996, Janet Yellen, who at the time was a member of the Federal Reserve Board, asked Alan Greenspan how he defined price stability. Greenspan replied that price stability is inflation low enough that businesses and households do not feel compelled to alter their spending decisions. Pressed further to "put a number on that," Greenspan selected 2%.[1] This 2% is viewed as both a target and a limit: the Fed wants inflation to be 2% but not higher. In January 2012, the Fed announced that it was expressly defining price stability as 2% inflation as measured by core PCE.[2] By announcing the explicit target of 2%, the Fed

1 Paul Volcker, "What's Wrong With the 2 Percent Inflation," Bloomberg, October 24, 2018, https://www.bloomberg.com/opinion/articles/2018-10-24/what-s-wrong-with-the-2-percent-inflation-target.

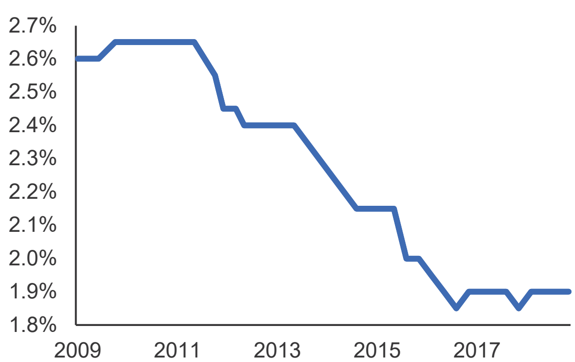
2 "Federal Reserve issues FOMC statement of longer-run goals and policy strategy," Board of Governors of the Federal Reserve System, January 25, 2012, https://www.federalreserve.gov/newsevents/pressreleases/monetary20120125c.htm

was anchoring inflation expectations: i.e., everyone knows what the Fed is targeting and therefore inflation expectations would remain around 2%. Investors consequently know that if inflation rises above 2%, the Fed will likely raise rates; conversely, if inflation runs below 2%, the Fed will likely cut or maintain rates. In 2016, the Fed further clarified that the 2% target was symmetrical — meaning inflation consistently running below 2% is just as undesirable as inflation consistently running above 2%.[3]

A question that one may ask is: why not inflation of 0%? Doesn't price stability mean that prices are, in fact, stable? If prices increase by 2% per year, prices will double over 35 years. That does not seem to represent stable prices. The Fed settled on 2% for a number of reasons. Over time, actual inflation tends to be lower than what the inflation indices suggest (there is an upward bias in the indices). Therefore, if the indices suggest inflation of 0%, actual inflation may be negative (deflation). Therefore, targeting 2% inflation lowers the probability of the economy experiencing a prolonged period of deflation. While the average person might welcome lower prices, most economists view deflation negatively for a number of reasons. If the economy is experiencing deflation, people may postpone purchases as they expect even lower prices in the future. With these delays, the economy may slow into, or remain in, a recession. Secondly, deflation increases the burden of debtors: $100 today would be worth more in the future and therefore a deflationary environment tends to depress economic activity.

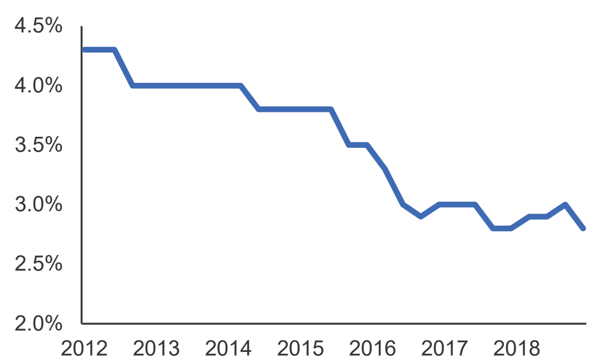
Another reason that central banks, including the Fed, prefer inflation to run slightly positive rather than at 0% is due to the relationship between inflation and interest rates. All other things held equal, higher inflation leads to higher interest rates. This allows the Fed to cut rates when the economy slows. Today, the federal funds rate is in the range of 2.25% to 2.5% as compared to 5.25% before the financial crisis. If the economy were to slow down, there is little cushion for the Fed to combat a recession by cutting rates. When the Fed adopted the 2% target, Fed economists estimated that the real fed funds rate over the longer term was 3%; thus, with inflation of 2%, the nominal fed funds rate would be 5%. This is relevant because historically, when the economy has slowed and the Fed has cut rates, the average cut has been about 500 basis points to get the economy moving again. Since the Fed publicly announced its target of 2% inflation, the Fed's projections for the neutral fed funds rate and real Gross Domestic Product (GDP) growth over the longer term have come down:

**FOMC Long-Term Real GDP Growth**




Source: Federal Reserve Board

**FOMC Long-Term Fed Funds Rate**

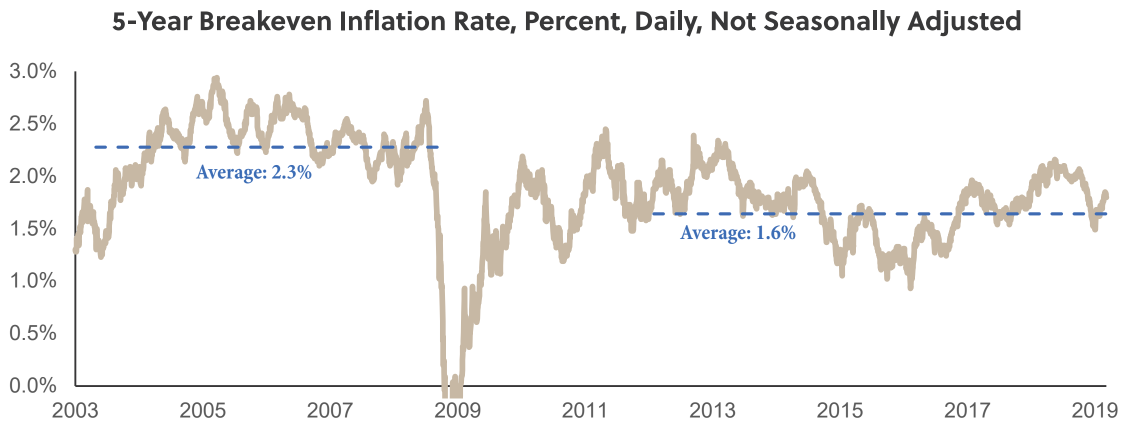



Source: Federal Reserve Board

3 "Statement on Longer-Run Goals and Monetary Policy Strategy Adopted effective January 24, 2012; as amended effective January 26, 2016," Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf

## Why Allow Inflation to Exceed 2%?

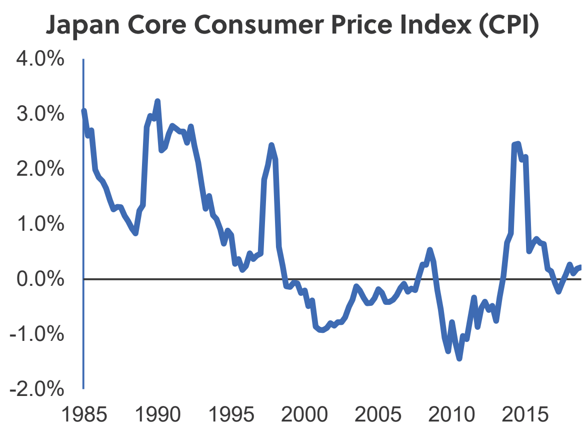
The Fed is concerned that with inflation running below the 2% target, inflation expectations could drift lower. There is some evidence that this concern has some legitimacy:



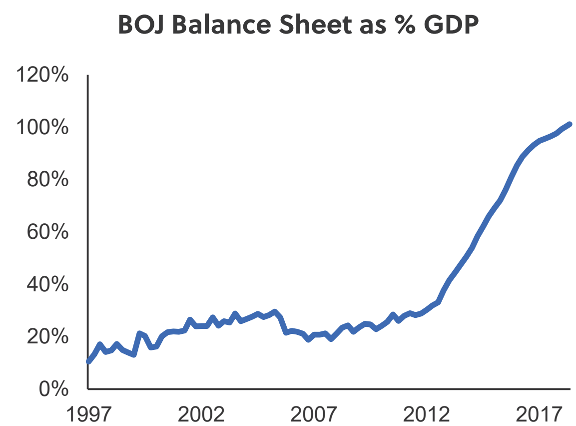
Source: FRED

Prior to the financial crisis, inflation expectations averaged 2.3% but have come down to about 1.6% since.

The experience of Japan shows that once a deflationary mindset sets in, it can be difficult to dislodge. Japan has been struggling with periods of deflation ever since its real estate and stock market bubbles burst in 1989-1990. Inflation has been running close to 0% with periods of deflation despite all efforts by the central bank of Japan (BOJ), including expanding its balance sheet to 100% of GDP, to lift inflation to approximately 2%. Indeed, the BOJ has had to give up its goal of 2% inflation in the near term.



Source: Bloomberg



Source: Bloomberg

While the U.S. has not experienced deflation since the Great Depression, the Fed is concerned about repeating the experience of Japan.

## Time for a Rethink?

The fact that inflation has been below 2% amid economic growth and falling unemployment is a cause for concern at the Fed. Lower inflation translates into lower interest rates, and this restricts the Fed's ability to fight the next recession. As a consequence, the Fed has embarked on a study to determine if its inflation framework should be changed. Of course, one easy approach would be for the Fed to raise the target from 2% to 3% or higher, a tactic which has been advocated by some economists. But, in the opinions of Ben Bernanke, former Chairman of the Federal Reserve System and William Dudley, former President of the Federal Reserve Bank of New York, the 2% target has now been established as the definition of price stability and raising it would be virtually impossible. Under the current structure of targeting inflation, past periods are not taken into consideration per the "let bygones be bygones" approach. One possible modification is to adopt a framework of allowing inflation to run above target for a period of time to offset lower than expected inflation during the most recent period so that the average over the business cycle is 2%. This approach is supported by some senior members of the Fed such as John Williams, President of the Federal Reserve Bank of New York.

If the Fed had adopted this approach in the past, perhaps the Fed would not have raised rates as aggressively in 2017 and 2018 and, furthermore, not reduced its balance sheet to such a degree. The Fed raising rates was justified in terms of its expectation that inflation was moving toward the target of 2%. Under a framework that inflation needed to overshoot to offset the period of lower than 2%, the Fed may have been more patient.

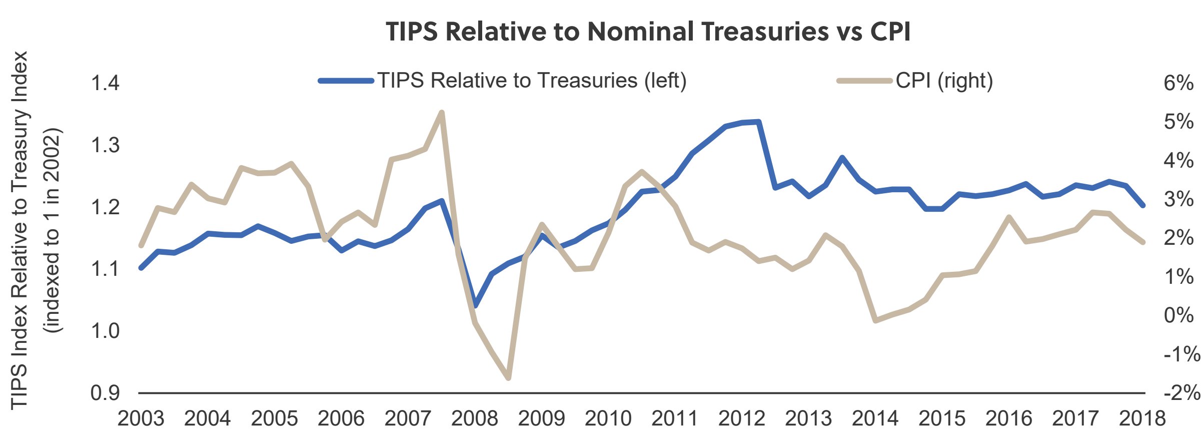
While the Fed is currently conducting its analysis and no changes have been announced, the approach to target an average inflation is gaining supporters. In a February 2019 interview, Dudley predicted that the Fed would likely change its framework for targeting inflation from the current "let bygones be bygones" to a framework where it targets an average inflation level of 2% over time.[4]

## Investing Implications

Under a framework where inflation is more variable and can go prolonged periods of below or above 2%, investors may need to pay more attention to inflation in making investment decisions. In structuring portfolios, investors need to consider and analyze whether we are in a period where inflation is likely to run above or below 2%. In other words, investors can't simply ignore inflation but need to be tactical with respect to hedging inflation. Some of the asset classes that investors may want to consider to tactically hedge inflation include Treasury Inflation-Protected Security (TIPS), real estate and commodities.

### TIPS

The interest income paid by TIPS is based on a principal amount whose value is inflation adjusted. In addition, at maturity, investors receive the greater of the original par value or the inflation-adjusted value. Given the real return characteristics, TIPS tend to outperform Treasuries during periods of rising inflation. During transition periods between lower inflation and higher inflation, investors may want to consider including TIPS in their portfolio or overweighting TIPS versus nominal Treasuries. During periods when inflation is expected to come down below 2% and remain at that level for a period of time, investors may want to consider removing TIPS or underweighting them versus Treasuries:



Source: Bloomberg

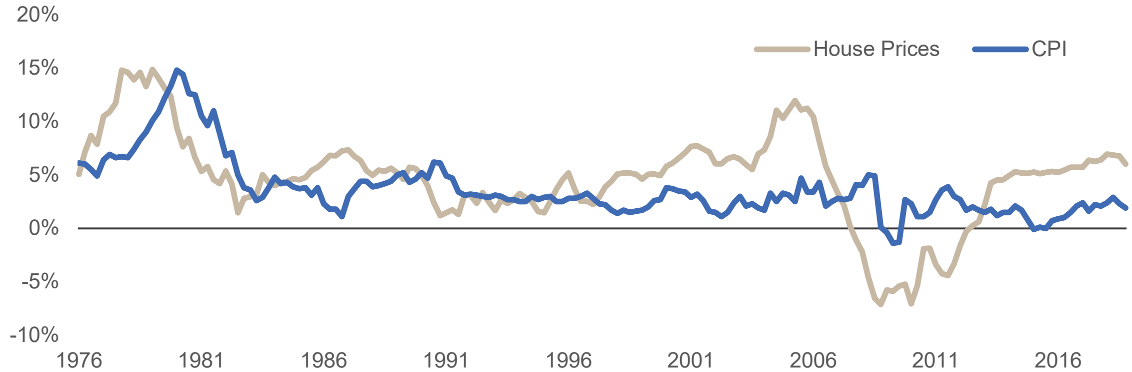
4 Matthew Boesler, "Fed Will Probably Change Its Approach to Inflation, Dudley Says," Bloomberg, February 15, 2019, https://www.bloomberg.com/news/articles/2019-02-15/fed-will-probably-change-its-approach-to-inflation-dudley-says

## Real Estate

Real estate is another asset class that can help investors hedge inflation following periods of lower inflation (and investors believe we are entering a period when the Fed will allow inflation to exceed 2%). Real estate has inflation-hedging qualities based on how investors value real estate assets. For example, rental income tends to rise along with inflation. Therefore, if higher inflation is expected, the value of rental properties increases because the expectation of higher rent translates into higher expected cash flows, causing the present value of the asset to increase as well. Another example is replacement cost. One approach that investors use to value real estate is to analyze what it would cost to build a comparable property, and, since construction costs rise along with inflation, higher inflation translates into higher replacement cost and higher valuations.

Of course, there isn't a one-to-one relationship between inflation and real estate prices. Other variables also come into play. For example, rising home prices during the recent housing bubble were not caused by inflation, but rather perceptions that house prices can only go up combined with certain financial innovations that allowed people to buy homes they couldn't afford.

**House Prices Annual Appreciation versus Inflation**

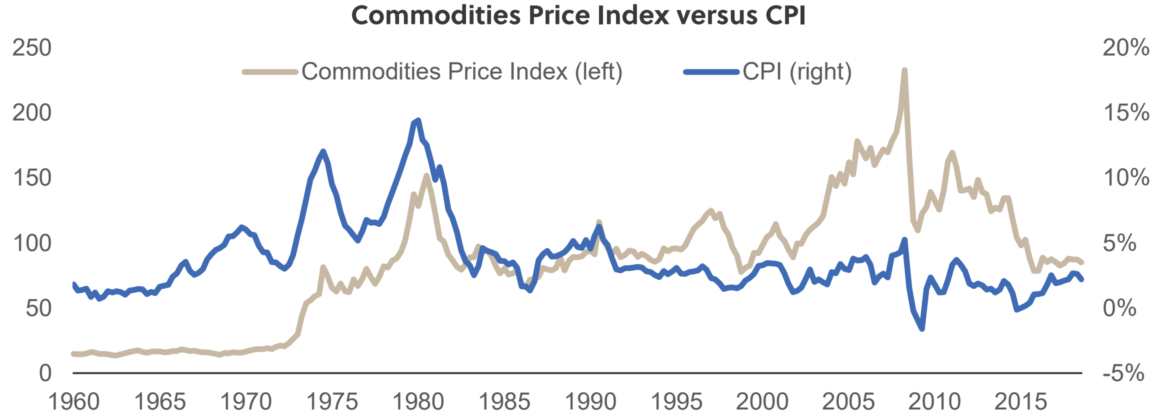



Source: Bloomberg

## Commodities

Commodities can also help to hedge inflation during periods when inflation is rising. During these periods, investors may want to include commodities in their portfolio. Of course, higher commodities prices elicit both a demand and supply reaction. Users of commodities begin to consider possible replacements for the commodity whose price has increased. On the supply side, higher prices cause the commodity producers to produce more supply, which then causes prices to stabilize. Like TIPS and real estate, investors need to be tactical in including commodities in their portfolios:

**Commodities Price Index versus CPI**




Source: Bloomberg

## Conclusion

We do not expect the Fed to change its inflation framework in the near term. In a recent speech, Chairman Jay Powell indicated that the bar for changing the framework is high.[5] Any change would only come after careful study. According to Powell, the Fed is not looking to change the 2% target but rather how the 2% is defined: whether the target is 2% every year or an average over an intermediate period. The need to carefully explain to households and the markets how the Fed views inflation means that the inflation-targeting policy cannot change in short order. Over the next year or so, we expect senior Fed officials to offer comments and make speeches explaining their views on the benefits and drawbacks of the various inflation targeting frameworks. We will be closely monitoring possible changes to the Fed's inflation targeting framework and continue to carefully consider what implications any changes may have on our investment management of client portfolios.

5 Jerome H. Powell, "Monetary Policy: Normalization and the Road Ahead," Board of Governors of the Federal Reserve System, March 08, 2019, https://www.federalreserve.gov/newsevents/speech/powell20190308a.htm