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Fed Thoughts: Back to the Future

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Officials of the Federal Reserve (Fed) make both strategic and tactical decisions. Strategy is about how best to achieve the Fed's dual objective of maximum employment and stable prices, contingent on the medium-term economic outlook, and shapes the contours of the policy rate over the next few years. Tactics are about how to implement that strategy and dictate the next rate decision. In our view:

- Nothing on the policy rate comes at the next meeting of the Federal Open Market Committee (FOMC) on October 31 and November 1. Fed Chair Powell hates surprising markets, and over the intermeeting period, officials have not contested the near-universal expectation that the funds rate will remain in its current range of 5¼ to 5½ percent.

- The import of the two-day session will be packed into Chair Powell's press conference, where he'll offer guidance about the Fed's strategic decision. We'll probably learn that Fed officials lean toward nudging the policy rate a little higher but are certain about keeping that rate on an elevated plateau well into next year.

What's the Big Picture?

We believe the Fed is near the end of a long journey to bring its nominal policy rate into the neighborhood of 5½ percent. Many investors are like impatient children in the back of Chair Powell's Tesla, asking truculently, "Are we there, yet?" and hoping to return to the home where a low fed funds rate flattened the vista of market yields and equity prices had a monetary backstop. In our view, the Fed is not going back there anytime soon, notwithstanding the whining.

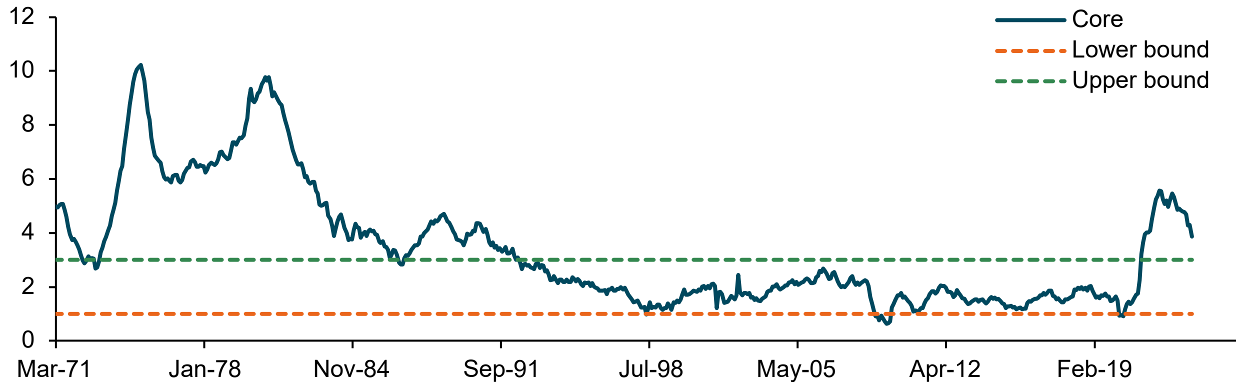
It's not complicated, looking past the distraction of the new "science" of monetary policy, with its big general equilibrium models, statistical inference of unobservable concepts such as the neutral rate of interest and the natural rate and quantification from a collection of policy rules.

The modern era of policy sorts into two regimes depending on whether price stability prevailed, as characterized by former Fed chairs Volcker and Greenspan. For them, price stability held when variable prices were not material considerations in the decisions of households and firms. That is, price stability held when inflation was not salient in the public's consciousness, which they roughly measured as a zone between 1 and 3 percent, shown in the first chart on the following page, using the personal consumption price index excluding food and energy.

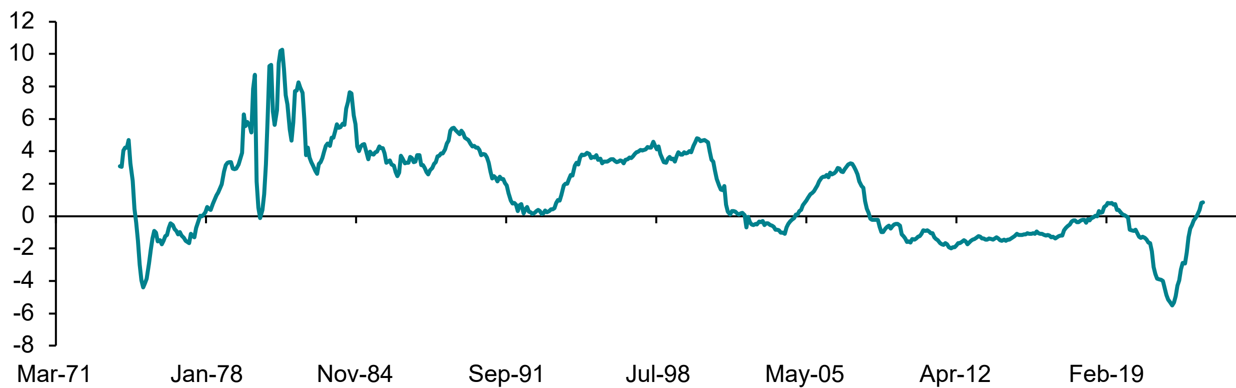
- Inside the zone of price stability, the Fed's credibility in keeping inflation low isn't questioned because we believe the public isn't concerned about inflation. This was the familiar surroundings of the first part of this century when the disinflationary forces of global trade and supply-chain innovation allowed the Fed to support demand by keeping the policy rate low and buffering equity market downturns. Indeed, the Fed was aggressive in that pursuit at times, based on the concern inflation may get too low and bring the zero lower bound to nominal rates into play. This was the playbook in the waning days of the Greenspan era and all the experience of Bernanke and Yellen. It was also the Fed during Chair Powell's early days.

- Outside the zone of price stability, we believe the public is concerned about variable prices. In our view, the Fed must keep the policy rate restrictive and accept equity price downturns to restrain demand, contain inflation and protect its credibility. That neighborhood is the rougher one of Volcker and Greenspan in the last quarter of the 20th century.

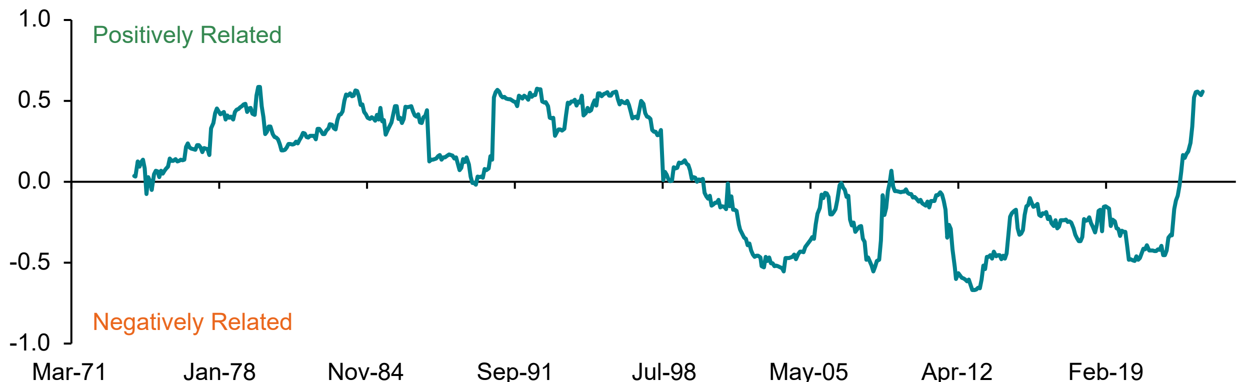
Personal Consumption Expenditure Inflation, Total and Excluding Food and Energy
Twelve-month change, percent



Real Fed Funds Rate
Nominal rate less twelve-month change in core PCE prices, percent



Correlation of Monthly Changes in Equity and Debt Prices
Over three-year moving window



Source: Inflation is measured using the personal consumption price index (PCE), excluding food and energy (Bureau of Economic Analysis). Upper and lower bounds follow the definition of Volcker and Greenspan of price stability. Real fed funds rate is the nominal policy rate (Federal Reserve) less the twelve-month backward-looking change in core PCE prices. Correlation is estimated from the three-year backward-looking association between monthly changes in equity prices (Wilshire 5000 total price index) and the price of marketable Treasury debt (FRB Dallas). Accessed via FRED, 10/17/2023.

What Happened?

A brief narrative of monetary policy over the past few years is that the 20th century intruded on the complacent 21st century. The pandemic was a tectonic sectoral dislocation that shut down the service sector. Policy interventions maintained overall demand, which shifted toward goods and dislodged the favorable disinflationary trend of the prior two decades. The Fed belatedly recognized the shift, but not until prices became unanchored. Having dug a deep hole of policy accommodation that put the funds rate at a 40-year low in real terms, Chair Powell had to negotiate a steep climb in the policy rate. Most of the 525-basis-point increase in the target rate represented the removal of ease, and only at midyear did policy become restrictive. Even then, we feel investors' faith that recent history would recur emboldened risk taking and limited the firming in overall financial conditions that would normally accompany such a massive Fed shift. This is a misreading of history by investors that Chair Powell does not share. We feel his policy plan is to keep the policy rate restrictive in real terms until he "sees it in its works" (as he frequently repeats) in inflation assuredly returning to the zone of price stability.

This might imply another quarter-point turn of the monetary screw at the December meeting to bring the rate target to 5½ percent. If so, the Fed's operating tactics dictate that Chair Powell convey a strong signal at his upcoming press conference, subject to his usual qualifications. However, a quarter point here or there is immaterial to its major strategic decision of keeping the funds rate restrictive for some time. That plan was made plain in September by the ½-point upward revision to rate guidance for 2024 in the Summary of Economic Projections (SEP). The smaller nominal rate cut that remains penciled in for next year in the SEP is less than the expected decline in inflation, implying that policy firms in real terms. Note, the Fed is forecasting "high for long" even as it also forecasts economic growth to slow and the unemployment rate to rise. Note also that this is the same Fed that hiked in ¾-percentage-point increments when its staff was forecasting recession and tightened amidst bank runs in March. This is last-century monetary policy.

Why Does it Matter for Portfolios?

Understanding the Fed's trip back in time is consequential for risk taking and portfolio allocation. It also appears in the data, as in the second and third charts on the previous page, in terms of the real policy rate and the rates of return and correlation among asset classes.

- Inside the zone of price stability, the real fed funds rate runs on the low side of its longer-run average. With long stretches of low, often negative, real rates, estimates of the neutral rate drift down. Stock and bond prices are negatively correlated because the Fed eases, lowering yields on fixed-term assets and raising their prices, whenever stock prices fall. This makes bonds an attractive hedge for equities, lowering the term premium, and generally reduces the price risk in capital assets, making risk premiums similarly low.

- Outside the zone of price stability, the funds rate runs high in real terms and stocks and bonds are positively correlated. The latter follows from the Fed staying on a firming track even when equity prices fall, inflicting capital losses on both bonds and stocks, to restrain aggregate demand. The neutral rate drifts higher with the policy rate firm. And with bonds a less effective hedge for equities and the investing world a riskier place, estimates of the term and risk premiums tend to be higher.

The 20th century monetary policy strategy Chair Powell is following makes for a less hospitable investing climate. We believe short rates will stay high for some time. Bonds will be a less effective hedge for equities so longer-

term rates will realign up toward shorter-term ones. The awareness of greater risk will be associated with greater compensation for risk taking. The extent we've gone back to the future hasn't sunk completely into the investing psyche, yet. However, the longer and more transparently the Fed keeps the policy rate "higher for longer," the more likely it will.

Vincent Reinhart
Chief Economist & Macro Strategist

Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Disclosure

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