The Federal Reserve made no policy changes at today's meeting, as expected. The fed funds rate was kept at the zero bound of 0.00-0.25%.

The formal statement was little changed, noting that the pace of recovery is moderating, with 'weakness concentrated in the sectors most adversely affected by the pandemic.' There were no dissents. They did note that the overnight repo facility will be closed down by February, as it appears it's no longer needed (it had low volume as of late). There was no change to the language about staying accommodative. Much of the speculation before the meeting was centered on trying to gauge the Fed's timetable for asset purchases (on adding to the purchases and/or when they'll end), but there was no clarity on this. Also, there have been calls for the Fed and U.S. Treasury to 'lock in' low financing rates by extending the average maturities of the portfolio and move issuance to new debt to longer maturities, including perhaps issuing a 50-year bond, as other nations have, but no announcement as of yet.

This is how the key Fed inputs look in early 2021:

Economy: The negative growth of 2020 is expected to be followed by above-average growth in 2021 and 2022, assuming re-openings and pent-up demand are unleashed. This is particularly true in more cyclical segments like services. This is the typical pattern after recessions, let alone accounting for the more historic weakness from a pandemic. On the other hand, a variety of areas less sensitive to human distancing have rebounded—such as manufacturing. The pace of full recovery remains very tied to the ability of global governments to distribute vaccines, and any wrinkles along the way. If the base case is the majority of the population being inoculated by the end of Q2 or into Q3, this growth may come at a faster pace. If not, delays may push the full recovery out by months or even quarters. Eventually, following the near-term period of higher catch-up growth in the mid-single digits, it's expected that the economy will get back to moderate long-term trend growth of 2.0-2.5% or so. A return to pre-Covid conditions would cause the Fed's accommodative policies to look increasingly less needed, although the depth of the recession may have caused some residual damage that may take longer to repair.

Inflation: The most recent CPI results have again fallen below the Fed's target of 2%. As they've communicated recently, the Fed is determined to let inflation rise above 2% for a time ('run hot') to offset the persistent disinflation. How this plays out in reality remains to be seen. Maybe amazingly, average trailing core inflation rates for the past 25 years have averaged at around 2%, which represents far more stability than in some prior decades. Despite the obsession over it, whether it drifts a quarter-percent above or below that average may not be that meaningful. Unless inflation moves substantially higher, it's difficult to see the Fed normalize rates for that reason alone quite yet.

Employment: Labor markets remain unsurprisingly challenged, due to Covid's impacts on lower-end services jobs particularly. Enhanced unemployment benefits have helped somewhat, but conditions are difficult and uncertain for many, which is why stimulus has remained such a focus for Congress. The Fed's change in priority to a more asymmetrical focus on improving employment, as opposed to slowing down employment gains, would continue to validate a 'lower for longer' policy.

Entering 2021, monetary policy is about as accommodative as it can be. Without moving short-term interest rates into negative territory, or ramping up purchases of treasury and agency MBS, complimentary stimulus must come from other areas. Congress has taken on this challenge through fiscal stimulus, and appears ready to do more under a Biden administration and all-Democratic House and Senate (even if negotiated down from the original $1.9 tril.). The just sworn-in Treasury Secretary, former Fed Chair Janet Yellen, has voiced support for additional fiscal measures as well, as a supplement to Fed policy. This unprecedented level of aid, and assumed positive impact on business and consumer spending, has underpinned strong financial market results. There is debate on both sides about the appropriate valuation for risk assets as the recovery is proceeding, but one reality is that financial markets have looked further out on the horizon for earnings normalization, which has made near-term valuations (using still-recovering lower earnings) look richer by comparison. However, this varies by sector and spectrum of company quality.

An open-ended question is: When will interest rates rise again? The Fed itself has estimated low rates for several more years, with the pace of recovery being the key factor in the timeline. As has been the case with the modern Fed, signaling and messaging will be important to markets, before any concrete action occurs. Despite historical relationships calling for a natural level of rates being somewhat higher, this doesn't necessarily mean rates will rise substantially. Demographic and longer-term growth considerations continue to hold down overall growth potential and fears of such a spike.

Easy monetary and fiscal policies are a double-edged sword. On one hand, mainstream economists seem to agree that stimulus has been necessary to bridge the spending and income gaps during a surprise pandemic event. Although it hasn't solved every problem, economic damage would have been worse without it. On the other hand, there is concern that larger federal deficits and debt levels will place a burden on generations to come, and raise the potential for inflation, as more money sloshes through the system. There are headwinds that could keep inflation at bay in the near-term, but the fears could remain in the background for years.

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