

The Federal Reserve Open Market Committee made no change in policy, keeping the target short-term interest rate at 0.00-0.25%. Similarly, no change was made in the pace and magnitude of ‘quantitative easing,’ which is the ongoing treasury and mortgage bond purchase program.

The formal statement showed an upgrade in the economic outlook, with 2021 growth from 4.2% to 6.5%, unemployment lower from 5.0% to 4.5%, and PCE inflation up from 1.8% to 2.4% (core to 2.2%). However, it was noted that most sectors and inflation remain weak. On the dot plot graph, four members now believe a rate increase in 2022 is likely, while seven remain hinged on 2023.

In looking at the Fed’s mandates, all have improved, which raises questions about the timeline for keeping a low rate policy intact:

Economy: The economy is naturally still recovering from the Covid shock of 2020, with an annual GDP decline of -3.5%. Expectations for 2021 have been entirely vaccine-dependent, now evolving to distribution- and herd immunity-dependent. With inoculations ramping up in the U.S., estimates have widened to somewhere between 5-10%. Growth rates for 2022, and the next several years, in fact, are anticipated to still be higher than normal, before ratcheting back down to the Fed’s central tendency of 1.7-2.0%. Faster normalization would lead to an earlier departure from accommodative policy.

Inflation: This has been the crux of recent market concerns, although the February year-over-year CPI reading fell at a fairly tempered 1.7% headline and 1.3% core level<sup>1</sup>. The fear is that the sharp increase in the monetary base (M2, specifically) and immense size of the fiscal stimulus packages could flow through to higher goods prices and wage levels. In the past few months, stronger consumer demand coupled with supply and transportation bottlenecks have raised producer costs for some goods, but the effect is expected to be transient. Rising consumer inflation expectations (beyond current levels of 2.5-3.0%) are another thing the Fed worries about, since these can fester and sometimes affect consumer behavior. At the same time, expectations have tended to run a full percent above core CPI for the past 20 years<sup>2</sup>, so haven’t been overly predicative of long-term inflation. The consensus opinion from economists seems to be that a short-term spike in inflation is likely, as the economy ramps up (similar to ‘restarts’ in the past, like the 1920’s and 1940’s), but levels may abate over the next year or two. This conflicts with the fears of ‘too much money chasing too few goods’ brought on by massive government fiscal spending, as in the late 1960’s/early 1970’s. Stimulus amounts of today’s size haven’t been tried before, though, so the multi-year effects remain untested. The Fed has been clear about wanting inflation to ‘run hot’ (over the 2% mandate) for a bit, which would keep policy accommodative based on this measure.

Employment: Labor markets continue to improve, although the last few months have been held back a bit by severe winter weather. The worst conditions continue to weigh most heavily on lower-wage service workers, who have been the most displaced by the pandemic’s lockdowns. Broadening vaccinations and re-openings are directly helping unemployment, with extended benefits and stimulus payments bridging the gap. These still-challenged conditions push the Fed to keep policy accommodative. There have been some political calls for the Fed’s labor mandate to broaden even further, towards narrowing perceived economic inequality, although economists debate whether or not central bank monetary policy is the most effective tool for these efforts.

This was a more closely-watched meeting compared to the last few. Markets appear to be looking for a capitulation point where the Fed acknowledges that ‘enough’ recovery in the economy and labor markets has occurred. There aren’t signs we’re there yet, and could still be far from it, based on the own admission of Fed officials in their regular speeches. They’re leaning toward the side of more stimulus for longer, as opposed to erring by pulling back too early (a mistake made during the Great Depression that has echoed in the halls of the Fed since the 2008 financial crisis).

But when will the taper begin? The drawn-out low-rate and stimulative environment lasting through 2024 and into 2025 might now be seen as overkill—the appropriate time could be a year or so before that. Along with the recent rise in inflation expectations, this has caused long-term interest rates to tick higher.

The Federal Reserve currently owns nearly \$5 trillion of U.S. treasury securities. The first step in any tightening would be communication about the future pace of the Fed’s bond-buying program. The ‘taper tantrum’ of 2013 is a prime example of the market’s sensitivity to any future changes in bond interest rates. While a repeat is something the Fed would like to avoid, it’s not possible to make financial markets happy constantly. (It’s now hard to imagine back to the time when the Fed would simply ‘act,’ without press conferences, or announcing nuanced policy intentions for the future.) While low rates now appear appropriate for the economy to recover from a generational pandemic, an expansionary policy kept in place for too long can risk economic and financial market excesses, including bubbles in certain assets. Perhaps the Fed believes a better idea is to let a process of ‘rate normalization’ take hold in fits-and-starts.

For now, interest rates generally remain low on both a historical nominal basis, and especially as after-inflation real yields, where long-term rates have hovered around zero for a decade. Some signs have obviously already happened, but eventually, rates may move higher to more expected levels. However, ‘higher’ doesn’t necessarily mean ‘high.’ Economic reflation may not be preferred environment for owning long-term treasuries, but bonds remain critical as a portfolio insurance component (just in case risk assets don’t work out as well as hoped). Reflation of spending and earnings may continue to foster a good fundamental environment for equities, especially small cap and international (the latter particularly if the U.S. dollar weakens compared to more cyclical foreign currencies), as well as commodities. Risk assets generally have benefitted from improving activity historically.

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Data Sources:

<sup>1</sup>U.S. Bureau of Labor Statistics

<sup>2</sup>Federal Reserve Bank of St. Louis, FocusPoint Solutions Calculations