

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com

Christofer.Langner@bankfab.com

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Investors await Fed clarity on how the new framework will work

◆ Central bank is set to clarify how exactly it calculates the 'average' inflation it is now targeting.

◆ Investors will also be watching the economic projections of Fed governors as the US recovery has been faster than expected.

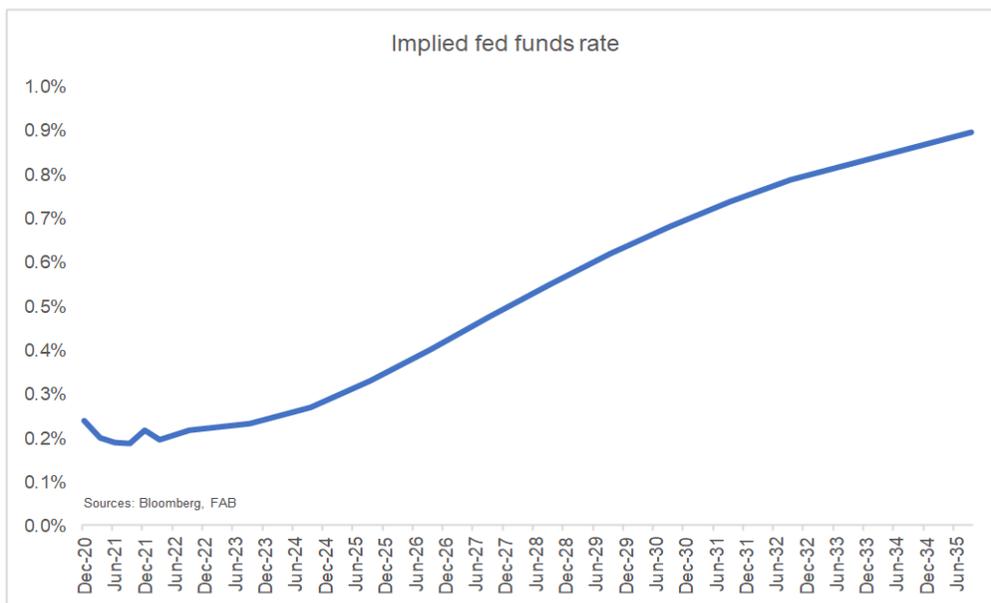
◆ While a less-dovish statement could unsettle markets, investors generally expect the Fed to stay the course.

◆ This means the central bank will probably say interest rates will remain low for at least two more years.

◆ The FAB AAC favours hard currency emerging market debt and investment-grade corporate bonds.

Since Alan Greenspan took the helm of the Federal Reserve on 11 August, 1987, the world's key central bank has slowly moved from a secretive stance to a more transparent one. Whereas in the days of Paul Volcker, and even in Greenspan's early days, investors had no clue of what would come out of a Federal Open Market Committee meeting, nowadays there very seldom is a surprise.

In fact, Chairman Jerome Powell has taken transparency to an extreme, mandating that, for the first time, there is a press briefing after every Fed meeting. Despite all that, investors are highly uncertain about what is going to be said in the statement that will be published later today. The main reason is that after a nearly two-year review, the Fed has changed its policy framework and this is the first meeting after that shift. Among other things, now the bank targets an average inflation instead of a number.



The questions begin right there. An average inflation needs to be calculated over a certain period of time. Nobody knows what that period is. Given the Fed's preference for longer-term measures, it is not likely to be short-term. For instance, instead of the monthly CPI numbers of the Bureau of Labor Statistics, the Fed bases its policy-setting on the quarterly core personal consumption expenditure deflator of the Bureau of Economic Analysis. The choice aims to avoid the 'noise' from the more frequent data.

In the past decade, the monthly measure was only higher than 2%, the Fed's target, for 10 months, six of which were in 2018, when the central bank felt emboldened to start raising rates. The rates move, however, proved premature and that is, perhaps, part of the reason why the Fed reviewed its policy framework and is now targeting an average over time instead of a fixed number. The problem, again, is over how long? The answer will be given today, and will probably be in years.

The market is indicating that it does not see US rates at even 1% for at least 15 years

Regardless of the exact timeframe, one thing that markets do know is that the Fed is unlikely to increase rates for a very long time. The current summary of economic projections (the so-called 'dot-plot') has the benchmark rate at zero at least until 2022. The bank's long-term equilibrium rate is still seen at 2.5%, which is already lower than the 2.75% of only two years ago, but that could also move lower.

If market-implied rates are to be taken seriously, the equilibrium rate will shift a lot lower. Fed fund futures are pricing sub-1% benchmark yields at least until 2035. While that is a highly inaccurate measure, it does show that investors expect a very dovish Fed. And if that is the case, then investors will only have one option: to buy riskier assets which offer higher yields.

Investment Strategy Update

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