Eriswell Market Insights

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Fed's Policy Shift: What does it mean?

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The Federal Reserve has chosen the lesser of two evils: a carefully judged shift towards NGDP-targeting as opposed to possibly entrenched deflation. Will stock investors respond? Will households and businesses keep believing? Investors probably more so than consumer and businesses.

This is quite a technical note on monetary policy, but the key point is achingly simple. Yet, it is something equity investors keep underestimating.

Back in January 2013, we wrote:

> *"We have compared conventional monetary policy (interest rates) to bows and arrows at the zero-lower-bound. Quantitative Easing upgraded this to rifles and pistols. Big new unconventional monetary guns are now being readied for action.*
>
> *"We foresee comments of 'too radical', 'too risky' and 'too reckless' giving way to shock and awe as the potency of this new weaponry dawns on investors."*

Heading into 2021: contrary to popular opinion ammunition for these weapons is NOT exhausted – NOWHERE NEAR! However, firing them introduces increasing levels of moral hazard and potentially serious future side-effects.

Let's now look at this week's announcement:

The Fed changes tack

The Federal Reserve's latest guidance is to expect zero rates until the end of 2023 and that it does not expect to tighten monetary policy until inflation has been higher than 2% "for some time". This deftly unlocks the immense power of NGDP-targeting while minimising the dangers of attempting a mandate shift during such perilous times.

There are formidable dangers associated with the ongoing acceleration of the intertemporal, intergenerational, and inter-societal shift of wealth. On one level, Western central banks have no credible alternative.

Afterall, which is preferable?

a) Allow our fiat monetary systems to collapse under the growing weight of outstanding debt

OR

b) Prop-up nominal-GDP (NGDP) to a degree which – if something comes along to restart productivity – will allow Western economies to grow and inflate their way back to stability

The answer has to be (b). Hence the Federal Reserve's unprecedented post-Covid-19 intervention. Measures to date are without precedent: 0–0.25% Fed funds rate, new forward guidance that zero rates are here at least until end of 2023, additional QE purchases, etc. Which comes atop expanded repo operations, increased lending to securities firms, direct lending to US banks, invocation of Section 13(3) of the Federal Reserve Act, back-stopping money market funds, buying commercial paper, relaxing regulatory requirements, direct lending to major corporates via the PMCCF, supporting loans to SMEs, direct lending to municipal administrations, and opening new FX swap lines.

Fed's new 'soft' price-level/NGDP-targeting regime

NGDP level targeting revolves around game theory and is consequently difficult to model. However, being behaviourally based, its key strengths are intuitive, namely that under NGDP targeting regimes – unlike current 2% inflation targets – the past becomes relevant in a manner which increases the potency of current policy.

The process works like this:

Historically, the Fed would explain the circumstances surrounding past inflation misses, commit to getting it back in line with its 2% target, and then basically just forget about it and move on. Under the Fed's new 'soft' price-level targeting regime, it must now make-up for at least part of past inflation misses to regain its pre-guided price-level path. Incidentally, price-level targeting and NGDP-targeting are barely distinguishable in the Fed's case given its dual inflation/employment mandate.

In terms of specifics, the Fed has not guided a formal price-level path: it has however taken a big step in that direction by guiding to expect no interest rate increases until at least the end of 2023, while indicating it would not tighten monetary policy until inflation had been higher than 2% "for some time".

The necessary inflation catch-up element was strengthened by Powell's comments on Wednesday:

> *"This is all about credibility and we understand perfectly that we have to earn credibility, ….. This framework, we have to support it with our actions, and I think today is a very good first step in doing that. It is strong powerful guidance."*

Advantages of Price-level/NGDP targeting

1. **Reinforce the USD inflation anchor**: bond, stock, and FX investors, businesses, households, and local authorities can now have a greater confidence that the Fed is going to deliver its mandate in that going forward, it is at least partially committing to make up for past inflation misses.

   Don't some argue that NGDP targeting risks de-anchoring inflation expectations? This is theoretically possible to the extent that the Fed will be unable to clearly communicate its new approach, a somewhat farfetched concern for an organisation whose communication skills are second to none.

2. **It's good news for US businesses, stocks, and the US economy:** knowing that inflation under/overshoots will be made up for later should increase confidence in future US economic outcomes and thereby support the best possible allocation of real resources to its economy.

   Central bankers put it something like this: NGDP/Price-level targeting, far from indicating an intention to tolerate inflation levels above declared inflation targets, is another step towards a future where the path of nominal aggregate income approximately equates to the levels anticipated by investors and borrowers at the time they took on their existing nominal investments and loan obligations.

Unknowns with NGDP-targeting:

1. While the idea of Price-level/NGDP targeting has been around since Irvine Fisher in 1911, it has never been tested in action. Partly because its side-effects cannot be easily modelled owing to a lack of empirical data.

   It would be reckless for the central bank of the world's largest economy and global reserve currency to be the first mover in this regard. In which light, the Fed's small steps seem prudent. Small steps which have hitherto included the Fed's post-2012 upward reweighting of US unemployment in its mandate, albeit set within a traditional Taylor type framework.

2. NGDP targeting may not provide a reliable anchor in today's productivity-stalled/zero-r* environment, where it is no longer possible to accurately specify future NGDP growth rates.

    a. Post-2000 improvements in technology have perversely reduced labour productivity, increased the share of national income earned by capital, and reduced the share earned by labour. This brings significant uncertainty as to potential future NGDP growth dynamics, probably why the Fed is emphasising the price-level aspects of its new policy.

    b. The effect of changing demographics on trend US GDP potential is difficult to estimate.

    c. Potential US GDP growth rates are being influenced by unprecedented EM competition for natural resources alongside unprecedented opportunities for Western firms to access cheap foreign labour.

    d. The manufacturing sector has an infinite capacity to improve productivity. When human brains can't innovate any more, we can always harness machines to do it for us. Not so for the service sector, a nurse can't treat infinitely more patients and a schoolteacher can't teach an unlimited number of kids. Replacing a local grocer with Walmart or Tesco improves productivity but cannot do so ad infinitum. It is possible that the increasingly service sector orientated US and Western economies have squeezed out most of the possible service sector productivity increases and now face an intractable problem.

    e. The influence on future NGDP growth and inflation of the 2000-2020 credit super cycle is hard to quantify.

    f. The output gap of a ZLB-trapped economy cannot be accurately estimated. Especially within economies possessing an intangible output gap such as Spain, the UK, Ireland, and even the US, where it is not solely a question of revving up old businesses after a slump, but a matter of deep reforms encompassing de-levering and a rebalancing away from traditional industries including construction, finance etc.

    g. Behavioural-Econometric hybrid models like Eriswell's in-house suite have hitherto done a good job of explaining private sector savings movements in conceptual terms. However, the '*human anxiety*' parameter is hard to measure as little empirical data exists of ZLB episodes where the savings rate flips from one stable savings surface to another.

Conclusion

A prudent central bank may conclude, ‘Come back when you’ve sorted that lot out’ …to which you may think, ‘Damn right!’ The Federal Reserve has instead chosen the lesser of two evils: a carefully judged shift towards NGDP-targeting as opposed to risking a far more damaging bout of entrenched deflation. The ECB, in time, must too decide between NGDP targeting and a violent Supernova ending for the euro. We naturally anticipate a similar shift.

Will stock investors believe the Fed? Yes, of course they will! We have previously highlighted the way the Fed and other central banks now harness religious psychological techniques for the purpose of encouraging investors, businesses, and consumers to replace immediate personal experience with a passive belief in the infinite power and wisdom of the central bank.

This is necessary because trapped at the ZLB, trouble beckons at the point we collectively stop believing. We have previously explained the way subconscious Jungian archetypes are routinely exploited in the advertising world. All of us have, from a very young age, been bombarded with these archetypes until it becomes something we instinctively recognise; something that strikes a deep chord within us. For example, *The Economist* image below with the tagline “Into the unknown” strikes an emotional chord because it speaks to our innate explorer and hero myths, and we have read/watched so many hero myths in our life that we can readily accept the Federal Reserve as another.

Will households and businesses keep believing if a major recession hits? This is a trickier question, and the Fed is already concerned about its inability to reach mainstreet and in particular the poorest 50% of US households. This could contribute to a deep recession if – having realised that the Fed can’t help them – the poorer US households choose to increase their precautionary savings rate. The Fed will probably continue to find it easier to influence investor behaviour than consumer and business sentiment.

This is the major risk as we see it, and while not quite imminent we need to start thinking about how to navigate the ensuing recession.

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