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The Fed's New Take on Inflation Targeting

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Over the last 10 years, the Federal Reserve's annual symposium in Jackson Hole, Wyoming has been a preferred venue for communicating monetary policy changes and initiatives. Chairman Jerome Powell did not disappoint this morning when he announced a modification to the Fed's 2% inflation targeting policy, which Ben Bernanke first introduced in 2012.

What is the New Policy?

Since its inception, the 2% level has only occasionally been reached and never exceeded. According to Powell, the Fed will now look to achieve this target on average. This approach implies the Fed will not begin tightening once the 2% target is achieved because the rate has been below this level for so long.

Fed policy is one of the factors often blamed for increased income inequality. Powell believes this policy change should allow for a stronger labor market, which could benefit low- and moderate-income families.

The Chairman also discussed the longer-term flattening of the infamous Phillips Curve, a theory developed in the 1970s to help explain and address the high inflation at that time. For the past 20 years, the intuitively logical relationship between inflation and unemployment has changed to the extent that the record-low unemployment rates achieved before the pandemic did not stoke the wage inflation postulated by the theory.

Powell did not provide much detail on the formula for defining the average inflation rate, which gives the Fed greater flexibility in implementing changes. Since inflation hasn't really been an issue for the last 10 years, the Fed could possibly allow the rate to move above the target for a long stretch of time. Even though Powell did say the Fed won't hesitate to act if inflationary pressures grow, the bank appears willing to let the economy run hot from an inflation perspective before tightening. Skeptics may conclude the Fed will become politically addicted to easy policies, which could provoke a return of high inflation.

What does this New Policy Mean?

Here are the preliminary conclusions to draw from today's speech:

- The Fed will not be quick to pre-emptively raise rates if the inflation rate exceeds 2%.
- Monetary policy will likely be easy for the foreseeable future, given the pandemic's lasting impact on employment.
- Fed ease and the resulting low interest rates have been cited as the primary factors driving equity valuations higher. As such, this policy change should be viewed favorably by the equity, commodity, and riskier fixed-income markets.
- The potential inflationary implications of this long-lasting, extreme monetary ease may eventually exert upward pressure on bond yields. But this appears far off right now as the economy continues to navigate the deflationary realities of a COVID-19 world, and the Fed continues to buy the increased amount of Treasury bonds issued to finance ever-increasing fiscal policy initiatives.

Please contact your Cerity Partners advisor with any questions.

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