

FED'S GONNA LET THE ECONOMY RUN 'HOT, HOT, HOT'

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While Powell & Co. didn't necessarily telegraph the Jackson Hole announcement regarding the [Federal Reserve's \(Fed\)](#) new policy framework, enough hints seemed to have been laid out of late suggesting this outcome should not be surprising. Nevertheless, I've watched the Fed for more than 30 years, and this new policy framework does represent a noteworthy shift in how [monetary policy](#) is now going to be delivered. Basically, the Fed is definitively stating that official policy can let the economy run "hot, hot, hot" in order to achieve its average [inflation](#) goal over time.

Let's back up a minute to clarify my opening thoughts. As I blogged last week, [Powell's speech at this year's Jackson Hole conference was going to be watched very closely by the money and bond markets](#) to see if any hints regarding the Fed's policy framework review would be dropped. In reality, Powell didn't drop any hints, but rather the bombshell itself, formally announcing that, going forward, monetary policy "seeks to achieve inflation that averages 2 percent over time." In other words, to quote the Fed statement: "Following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

Forward guidance will be an integral policy tool going forward in order to try and manage expectations (how long will the overshoot last?), and hopefully, volatility as well.

10-Year Breakeven Inflation Rate



Source: Bloomberg, as of 8/27/20.

What does that mean? Well, considering inflation has been undershooting the Fed's target for quite some time, monetary policy is now set to let economic conditions produce an overshoot of inflation in order to achieve its "average 2% target." The [U.S. Treasury \(UST\)](#) market is certainly paying attention. Look at how 10-year breakeven spreads (the UST market's inflation expectation gauge) have performed since hitting a bottom back in March.

What can investors expect? While rates can still stay historically lower for longer, I expect the Treasury [yield curve](#) to steepen, led by rising UST 10-year yields moving above the 1% threshold, and perhaps retracing back up to the 1 ¼%–1 ½% range later next year (assuming no further pandemic-related setbacks).

How Should Fixed Income Investors Position Their Portfolios?

1. Fixed income investors should consider: a) utilizing short [duration](#) strategies within their portfolio; and b) focusing

on Treasury [floating rate notes \(FRNs\)](#) instead of [TIPS](#) (real yields, aka TIPS yields, can still rise)

2. Position [credit](#) over rates in model portfolios with a more specific focus on core-plus solutions. This would include a [high-yield](#) sleeve that focuses on [quality](#), which could potentially benefit from this “new” monetary policy approach.

Unless otherwise stated, all data sourced is Bloomberg, as of August 27, 2020.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Inflation : Characterized by rising price levels.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Treasury Inflation-Protected Securities (TIPS) : Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securities.

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.