Meet the new Fed policy: Low interest rates for years to come

It's official: Interest rates will be low for (practically) forever. On Thursday, the Fed announced the conclusion of its highly anticipated multiyear framework review. The big reveal? We can expect short-term interest rates to remain at or near zero for years to come. For investors, the prospect of an investment landscape where income is scarce has become a reality that will need to be addressed—not just in the current economic crisis, but long after.

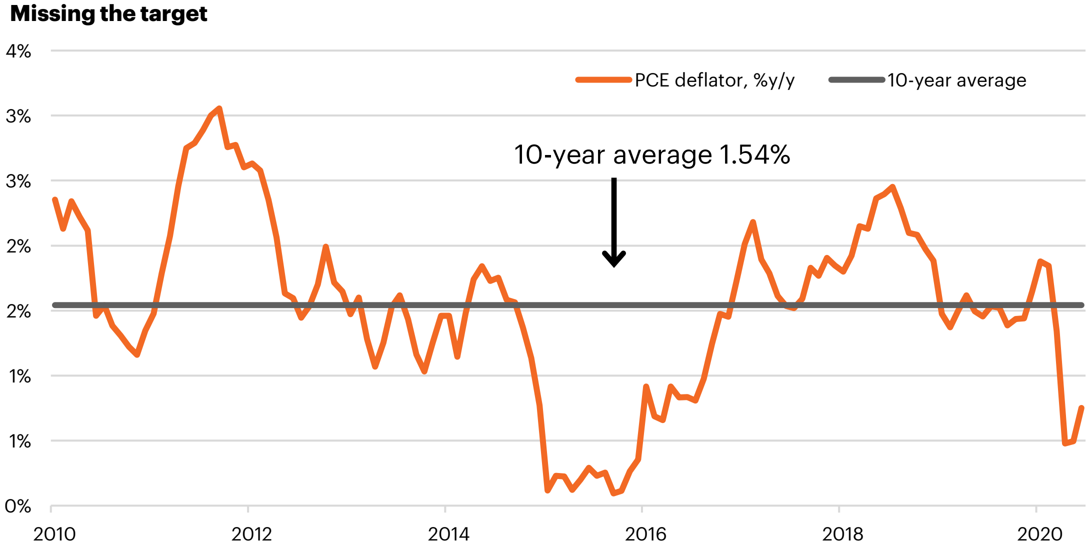
The announcement

The Fed made a small change with big implications. Policymakers shifted from targeting inflation at 2% to now targeting "inflation that *averages* 2% over time." In other words, periods where inflation is above 2% will now be entirely consistent with this new definition of long-run price stability. The announcement was in broadly line with what the Fed had signaled to markets and had been largely priced in. The Treasury market saw the biggest reaction, as the 10-year yield rose 8 bps to finish Thursday around 0.74%, but this is close to the middle of the range of the past 3 months.

The Fed's problem

What prompted the first official framework review since the Fed published its longer-run goals in January 2012? The big problem is the Fed has been chronically missing its inflation target of 2%. After vanquishing the inflation dragon in the mid-1980s, the Fed successfully managed inflation in the 1990s and 2000s. But fresh challenges emerged: low productivity, low potential growth, goods price deflation and a flatter (disappearing?) Phillips curve conspired to push inflation down. For the past decade, inflation averaged only 1.5%. Let me reframe that: During the longest expansion in U.S. history, with the economy growing at full speed and record job gains pushing the unemployment to the lowest in decades, inflation could not maintain a 2% rate.

Missing the target

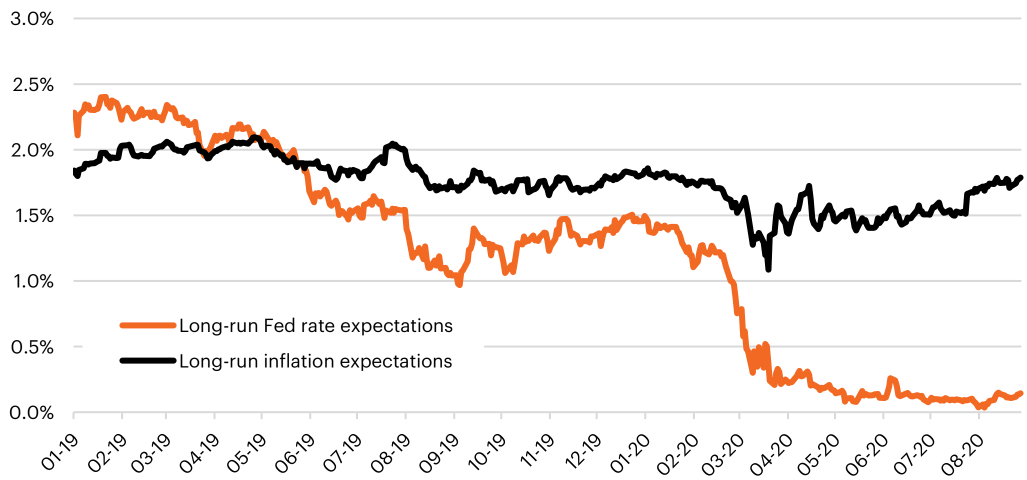


Source: Bureau of Economic Analysis, FS Investments, as of August 27, 2020.

Markets are already there

The reality is that markets had largely internalized the implications of this new policy. Market proxies for long-run inflation expectations and long-run Fed rate expectations show a new and stark divergence. Usually the two trade together: Higher growth expectations mean both higher inflation expectations and greater expectation that the Fed will raise rates. The growth and market shocks of Q1 sent inflation expectations plummeting to the lowest level since late 1999, and as the Fed slashed policy rates to zero, long-run Fed rate expectations also plunged. However, now 5-year forward inflation expectations have recovered to pre-pandemic levels (but note that they are still below 2%, the crux of the Fed's problem). Yet markets still expect that 5 years from now, the Fed funds rate will still be close to zero.

Inflation expectations and rate expectations have decoupled



Source: Bloomberg Finance, L.P., as of August 27, 2020. Note: Long-run Fed rate expectations are reflected by the 5-year OIS yield, and long-run inflation expectations are reflected by the 5Y-5Y forward breakeven.

The Fed's other problem

There is no magic bullet to solve the Fed's other problem—that with the Fed funds rate at zero, the Fed's toolkit is increasingly limited. The Fed acknowledged this challenge in its statement, saying that the Fed funds rate would likely be "constrained by its effective lower bound." The Fed is quick to point out that it has an unlimited ability to buy a wide variety of assets to stabilize financial markets and therefore support the economy. Yet clearly other facilities, like the Main Street Lending Program, were not as effective as initially hoped. Countries like Japan have been struggling with structurally sluggish growth, falling inflation and low interest rates for decades. Despite the Fed's broad reach and the thousands of PhDs contemplating this framework review, the reality is that further creativity may be required to truly fix low inflation, which has seemingly become entrenched.

What this means for the economy

Gone will be "preemptive" rate hikes. Remember the rate hike cycle of 2017–2018 when the Fed raised rates to 2.50%? The Fed raised rates as the unemployment rate fell close to the Fed's estimate of full employment, but before there was any sign of wage inflation or broader buildup of consumer price pressure. The new framework would change the prescription and hold off on those rate hikes.

One could argue that this conversation is irrelevant. We are in the earliest stages of a highly unusual economic recovery from the worst growth dislocation in living memory. The unemployment rate is 10.2%, higher than the peak of the last recession, meaning the Fed is far more focused on easing policy and supporting the economy however it can. But at some point, market expectations of rate hikes may sneak in. We expect the Fed to remind markets that policy has changed. Moreover, should a disruption in the supply chain cause inflation to increase, the Fed would have cover to hold off on reacting while maintaining its credibility.

We can also expect interest-rate sensitive sectors of the economy to continue to thrive. One recent example of this is the housing market, which has surged in recent months. This sector makes up less than 5% of GDP[1] but will likely be an important bright spot for some time.

Impact on investors: The impact of this lower-rate environment on investors cannot be overstated. Price appreciation has caused broad fixed income returns to look good, masking a devastating erosion in income. The Barclays Agg has gained 6.87% this year so far, but 5.85% of that return was due to price appreciation, leaving the remaining 1.02% due to income. The yield on the Barclays Agg is now just 1.17% and dipped to 1.02% earlier this month. The yield on the Barclays corporate bond index is 1.97%. All of these investments have benefitted from the precipitous drop in interest rates, but with yields now so low, future price gains are in serious doubt.

At the same time the Fed is pledging to leave interest rates low, the balance sheet continues to expand, albeit at a slower pace than the March–May buildup. The combination of added liquidity and emergency facilities to shore up part of the bond market may well continue to bolster returns across the risk spectrum.

The real issue for investors will be what comes after this economic crisis. Many hope that over the coming year or two, the economy will continue its recovery. This could happen even faster should a vaccine or more effective treatments help suppress the pandemic. But today’s announcement has made clear that even a return of steady, potential growth would mean the Fed would likely leave rates where they are—at zero. The end of the economic crisis would likely mean the end of liquidity measures, but not the end of the zero interest rate policy. In other words, a return to a pre-COVID economy would not mean a return to pre-COVID income.

1 The housing market’s share of GDP in 2019 was 3.1%.

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