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A Close VIEW

Tempting FAIT with Fiscal Policy

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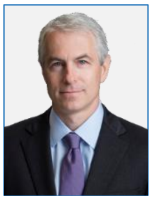

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The Georgia Senate election results have upended expectations for fiscal policy. The economic impact of fiscal expansion will be all the more impressive in light of the Federal Reserve's shift to Flexible Average Inflation Targeting (FAIT).

The Global Fixed Income team at MacKay Shields entered 2021 with a positive outlook for the US economy. We had no illusions about the difficult road ahead but were confident that a recovery would take hold and gain momentum over the course of the year. In particular, the rollout of a COVID vaccination campaign provided reason for optimism that the services side of the economy would begin to reopen more fully by the middle of the year. Fiscal relief for households had diminished during the second half of 2020, but the $900 billion aid package passed in December would provide a much-needed, albeit modest, lifeline for struggling households. And in the aggregate, the household sector had built up significant excess savings that could support the recovery.

Just days into the new year, we already had to revise these expectations. The Democratic Party emerged from the special US Senate elections in Georgia with two victories and razor-thin control of the Senate. This outcome immediately upended the outlook for fiscal policy. Democrats should now be able to move forward with an additional COVID relief package that will significantly improve the growth and employment picture for this year. As importantly, the Biden administration may now be able to implement some of its major spending initiatives in areas such as infrastructure, climate change, and health care, paid for in part by reversing some components of the 2017 Tax Cuts and Jobs Act (TCJA). Democrats will no doubt face challenges implementing this agenda. Still, at the end of the day, fiscal policy will turn more expansionary compared to a divided government scenario.

Clearly, Democratic control of the White House and Congress represents a regime shift in fiscal policy. The impact of fiscal expansion on growth and employment will be even more impressive in light of a second regime shift, this one in the Federal Reserve's monetary policy strategy. Under Flexible Average Inflation Targeting (FAIT), the Federal Reserve now seeks to re-anchor inflation and inflation expectations at two percent, and to do so will aim to achieve inflation somewhat above two percent in the years ahead. In support of this objective, the FOMC committed last September to holding the policy rate at its current level near zero until the labor market returns to maximum employment, and inflation has risen to two percent and is expected to exceed that level for some time.

FAIT is tailor-made to accommodate fiscal expansion. Under its prior strategy, the FOMC would respond to fiscal stimulus by bringing forward policy tightening in anticipation of stronger inflation, essentially leaning against the stimulus. This is exactly what happened in 2018 as the FOMC responded to the growth impulse from the TCJA, much to President Trump's displeasure.[1] With FAIT, preemptive policy tightening based on the inflation outlook is replaced by a focus on actual inflation outcomes. In addition, the goalposts for inflation outcomes have shifted as well, given the objective of

1. Between September 2017 and June 2018, a period that saw FOMC participants build fiscal stimulus into their outlook, the median FOMC participant's projection for the policy rate through 2020 increased by 50 basis points, according to the Summary of Economic Projections. The Committee continued with policy tightening through December of 2018 even as they revised their inflation expectations lower. The Committee would ultimately reverse course in 2019, cutting rates amidst a weakening outlook and after failing to sustain inflation at the two percent objective.

sustaining inflation above two percent in the years ahead. The potency of FAIT can also grow over time. As inflation rises but the policy rate remains near zero, the real or inflation-adjusted policy rate will fall further into negative territory, delivering additional stimulus to the economy.

FAIT also holds the potential for reducing market volatility around the eventual tapering of asset purchases. This is an important consideration for investors as there has already been market speculation – entirely premature, in my view – that fiscal expansion may lead the FOMC to begin tapering asset purchases later this year. This speculation comes against the backdrop of the 2013 Taper Tantrum, which saw an extended and pronounced bear steepening of the Treasury curve. One contributing factor to the Taper Tantrum was the unclear forward guidance on interest rate policy at that time.[2] As a result, Chairman Bernanke's discussion of tapering that spring not only impacted expectations for asset purchases, but for the path of short rates as well. Put differently, the Chairman's communications led to a wholesale revision in how the market viewed the Committee's policy reaction function. This can be seen in the graph below, where 3-month forward OIS rates are used as a proxy for policy rate expectations over one- and two-year horizons.

FIGURE 1: THREE-MONTH FORWARD OIS RATES DURING THE TAPER TANTRUM

Source: Bloomberg

FAIT can lessen the risk of a repeat Taper Tantrum because the stronger forward guidance on interest rates should leave market expectations for lift-off well-anchored. The Committee may begin communicating tapering plans later this year. If the inflation outlook has not changed meaningfully, these communications should not lead to a shift in expectations for the path of interest rates. Of course, this is a big "if." Sustained fiscal expansion combined with monetary policy that is willing to accommodate it has the potential to bring forward the FOMC's hoped-for period of inflation above two percent. This suggests that a meaningful shift in market expectations for the economy, rather than poor Fed communications, is the more likely trigger of repricing to higher rates. Meanwhile, FOMC participants can help ensure they do not contribute to market volatility by heading Chairman Powell's recent advice: "Now is not the time to be talking about exit."[3]

2. The 2013 guidance was a mix of time- and thresholds-based guidance, with the labor market threshold worded as a necessary but not sufficient condition for liftoff. Specifically, the policy statement at the time of the Taper Tantrum noted that, "a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase programs ends…" and that the target range would not be raised, "at least as long as the unemployment rate remains above 6-1/2 percent."

3. Jerome Powell, "A Conversation about 'Average Inflation Targeting', COVID Crisis, GFC, Debt, Swap Lines,…and Resilience," Princeton University, 14 January 2021.

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