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Weekly Commentary

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Paige Wilhelm
Senior Vice President
Senior Portfolio Manager
Federated Investment Counseling

Fed's new plan a double-edged sword

Last week, I wrote that the Federal Reserve probably was gearing up to release its revision of the "Statement on Longer-Run Goals and Monetary Policy Strategy" at the Federal Open Market Committee (FOMC) meeting in September. Apparently that wasn't a big enough stage. Chair Jerome Powell unveiled it instead at the annual Jackson Hole, Wyo., symposium of world central bankers, held virtually this year. This was a good move, as the change was significant and affects the world's financial network.

The framework itself is crucial; it influences every decision policymakers make. The only thing more fundamental is the Federal Reserve Act that established the Fed in 1913. And it isn't updated often—the last overhaul happened in 2012.

At first blush, the new strategy seems negative for liquidity products, but it really isn't. The Fed essentially adopted a lower-for-longer stance, pledging not to raise rates when the economy is getting better but only when activity is robust.

But this approach has good elements for the liquidity space. Previously the goal was to hit an inflation rate (measured by personal consumption expenditure) of 2%. Now, the Fed says it will tolerate a temporary rise above that level, and will primarily attempt to reach that by focusing on improving the labor market. The key phrase here that "policy decisions must be informed by assessments of shortfalls of employment from its maximum level." Until now, the FOMC viewed full employment as likely to drive inflation too high. Now, it will let it run as hot as needed to get to 2%, even if it overshoots that target. That plan could spur inflation sooner than many think after the pandemic ends, meaning the Fed could raise rates earlier and short-term yields should rise. Obviously, this must wait until after the pandemic subsides, but it will be intriguing to see if it happens not long after.

The London interbank offered rates (Libor) were mixed this week from last, with 1-month slipping 2 basis points to 0.16%, 3-month inching downward 1 basis point to 0.24% and 6-month remaining at 0.31%.

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