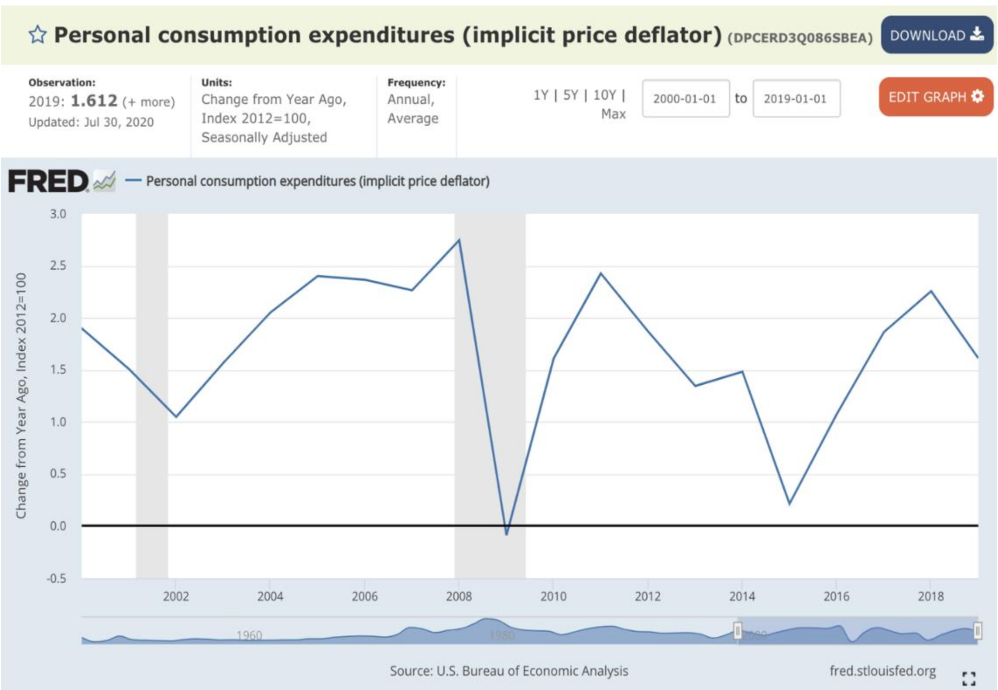
"Not Even Thinking About Thinking About Raising Rates"

Thus said Fed Chair Jay Powell this past June. But what exactly does this mean and why did he say it?

It's all about inflation. That is, the inflation we don't have. Missing in action. The Fed actually desires some inflation, at least a little, generally defined as 2%. Those old enough to recall serious thinking about inflation during Paul Volcker's tenure in Powell's seat at the Fed remember inflation being described as a catastrophe. Nothing crushes bond holder returns like unexpected inflation. Nothing damages consumer spending like inflation when personal income is constrained. Facing this, Volcker used the interest rate tool to crush it. Further, he broadcast the message that the Fed always stood ready to do so again. Given that, realistically, inflation hasn't made much of an appearance since that period from the late 1970s to the early 1980s. Why would the Fed want to rekindle it?



Since the recession in 2008, inflation as measured by the Fed's preferred measure, the PCE price deflator, has breached the target inflation level of 2% only in two years. The Fed sees this as problematic.

There are two accepted answers. First, central bankers view low inflation as a symptom of an economy that is moving too slowly and where increases in standards of living are challenged. Second, low inflation is coupled with low interest rates. Rates that are too low, in the eyes of the Fed, provide too little room to lower rates if/when the economy slows down. The Fed sees itself as having more flexibility to enact monetary easing when rates are somewhere above their current zero bound.

Since the Fed began to slowly divulge this public view of what should be its priority, we've had a pandemic. As we all know, the immediate response from the Fed has been to effectively maximize monetary accommodation. This includes lowering interest rates to near-zero levels plus engaging in significant purchases of fixed income securities, which raises their price and lowers their yield.

Powell and other senior Fed members are indicating that these policies are not likely to end anytime soon. The economic carnage from this pandemic includes a daunting rate of joblessness.

Recovery from this is likely to take years. The Fed wants to be seen as both supportive of job growth and tolerant of any inflation that might occur in establishing and maintaining the environment for that to happen.

This week, at the Fed's annual Jackson Hole meeting (which will take place virtually), Powell will give a speech titled "Monetary Policy Framework Review". We expect him to shift the language about the Fed's inflation tolerances to "average inflation". What this means is that the Fed will peg inflation at 2% as an appropriate level and will be tolerant of inflation running higher than that level, given that inflation has also spent considerable time running under that level.

Volcker is dead. So are the policies of his age. We expect Powell will shift the Federal Reserve toward more inflation tolerance. History will tell us who is right.