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Thoughts Ahead of the Federal Reserve Meeting

We believe there may be more uncertainty around the Federal Reserve's upcoming mid-September Open Market Committee meeting than is typical. It will be the first committee meeting since last month's virtual Jackson Hole meeting, at which the Federal Reserve announced revisions to its statement on longer-run goals and monetary policy strategy, and it is the last scheduled meeting before the U.S. election in November. We see four main possibilities as to what actions the Federal Reserve may take at this meeting: (a) provide forward guidance on the Federal Reserve Funds rate; (b) provide forward guidance on its asset purchase program; (c) provide both; or, (d) do nothing. We believe any forward guidance provided would be outcomes-based, meaning it would commit the Federal Reserve to an action until an economic target is achieved, rather than until a specified time has elapsed. The purpose of any Federal Reserve action would likely be to pivot from crisis management to a policy that may support and sustain the nascent economic recovery.

We think that either type of forward guidance could potentially move financial markets. In our view, it would be more challenging for rate guidance to be impactful, as investors already anticipate the Federal Reserve Funds rate will be pinned at or near zero for several years, in line with the Federal Reserve's own projections. Conversely, we believe investors expect asset purchases to continue at their current pace until the economy moves closer to the Federal Reserve's dual economic target of full employment and price stability around 2% inflation. We believe this is a more modest expectation that may be easier for the Federal Reserve to exceed should it choose to do so. If the committee were instead to sit on its hands and fail to act on either front in September, we believe investors may be concerned that Federal Reserve support is insufficient relative to expectations currently embedded in the capital markets. This could prompt a modest flight to safe assets, tempered by the likelihood that the expected forward guidance was merely delayed rather than foregone completely.

There are several reasons we think the committee may act in September. The acceleration of the long-term framework revision in August, which was adopted unanimously by the committee, effectively clears the decks for action in September. The framework revision appeared to impact capital markets by supporting risk assets and easing financial conditions broadly, gains that might be built upon by further action in September or squandered by inaction. There are also political optics to consider, as occurs in scheduled meetings ahead of every election, as the Federal Reserve endeavors to remain apolitical in both reality and perception. In this case, a failure to ease in September, if it were to be followed by a softening economy into the election, which then prompted an easing action at the next scheduled meeting two days following the election, could draw the ire of Republicans. Of course, stimulative action at the September meeting might be distasteful to Democrats. You can't please everybody, and typically the Federal Reserve handles this with a bias toward inaction ahead of elections, but we believe weighing the two risks falls on the side of some type of action in this case.

There are also several reasons the committee may choose to wait. The economy continues to advance off its lows, suggesting the need for additional stimulus is not urgent. There seems to be little evidence to date of a steep economic decline following the expiration of pandemic unemployment insurance on July 31 as some had feared, a development confirmed by last Friday's positive labor market report. Moreover, the daily toll of Covid-19 has appeared to improve in the U.S. in the last two months from its peak in July across new

new cases, hospitalizations, and deaths. At the same time, changes in consumer behavior in response to the pandemic have persisted, which suggests that another dose of Federal Reserve easing might not pack the same punch as if the Federal Reserve waited until there was additional progress on therapeutics or vaccines. Finally, we believe the Federal Reserve would like to keep the pressure on Congress to compromise on a fiscal stimulus bill to support the recovery.

As market participants weigh these factors, committee members delivered speeches last week that provided some incremental color while leaving plenty of wiggle room to keep investors guessing. In our view, the most important component of these speeches was what was not said. Specifically, the speakers did not take pains to prepare investors for action in September. In fact, Governor Brainard used the phrase “in the coming months” to describe when the Federal Reserve might use forward guidance to pivot fromcrisis management to policy in support of the recovery. Taking all of this into account, we currently expect the Federal Reserve to refrain from any additional changes to monetary policy until after the election. This view is subject to change, depending on developments related to the pandemic, the economy, legislation, and the capital markets. Indeed, uncertainty around the Federal Reserve’s next meeting appears to be higher than usual.