Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

FED SHADOW

Powell at Jackson Hole, and the Inflation Makeup Strategy

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Donald Luskin

A new license to let the economy "run hot." Goodbye Phillips Curve and "automatic pilot."

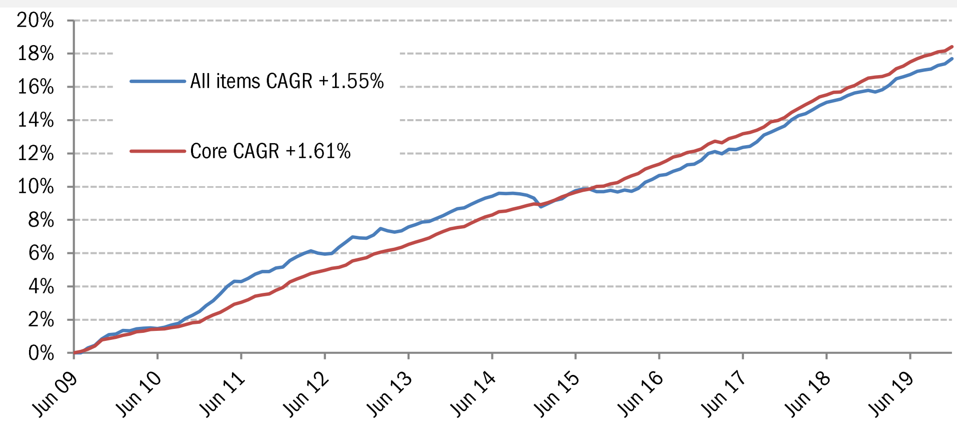
With Fed chair Jerome Powell's speech this morning at Jackson Hole, he is introducing the first amendment to the Statement on Longer-Run Goals and Monetary Policy Strategy since January 2019, following a lengthy review process.

- *The key change is the adoption of what amounts to an asymmetrical makeup strategy for inflation-targeting, in which the Fed will seek to run inflation above the target of 2% to make up for prior periods below target. But apparently it won't apply in reverse, that is, there is no policy commitment to run inflation below the target after prior periods above target.*
- Here's the text:

  "…the Committee seeks to achieve inflation that averages 2 percent over time, and therefore judges that, following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

- *Considering that inflation has run below target over the prior business cycle expansion (please see the chart below), the Fed has a lot of making up to do.*

Personal Consumption Expenditures indices, cumulative change over prior expansion



Source: BEA, TrendMacro calculations

Update to strategic view

US FED, US MACRO: Powell announces a new policy framework in which inflation will be allowed to run above the target of 2% after a period in which it was below target. It is asymmetrical – there is no commitment to run inflation below target after a period above target. There is no specific formula for levels or duration of inflation overshoot. This was broadly expected. It means the Fed will let the economy "run hot," definitively burying the growth-killing Phillips Curve and "automatic pilot" nonsense that marred Powell's first year as chair. With so much relief and stimulus in the economy, deflation has already been arrested after just three months and a tiny CPI dip. A rise in inflation may soon put the Fed's new framework into action – or, rather, inaction.

[Strategy dashboard]

- *Which means that the Fed will let the economy "run hot," and there won't be any more growth-killing nonsense about the Phillips Curve and reducing the balance sheet on "automatic pilot" just when the economy finally gets going again* (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018).
- *There's no specific formula for levels or timing of the anticipated target overshoots. Powell, in his speech this morning, characterized the new policy as "a flexible form of average inflation targeting."*
- This move flies in the face of what the Fed heard in its Fed Listens events last year, in which it sought policy input from a broad range of constituencies including minorities, underserved communities and retirees. The crystal clear message from those sessions was, as the FOMC put it in the minutes of the December 2019 FOMC, that "segments of the public generally do not regard the fact that aggregate inflation is running modestly below the Committee's 2 percent goal as a problem." Indeed, they prefer lower prices to higher prices.
- But it seems the Fed isn't really listening (see "The Fed Pretends to Listen" January 29, 2020). According to Powell this morning, without giving a reason, "a longer-run inflation rate of 2 percent is most consistent with our mandate to promote both maximum employment and price stability."
- If you accept that as a prior, then Powell's further logic is compelling:

  "…if inflation runs below 2 percent following economic downturns but never moves above 2 percent even when the economy is strong, then, over time, inflation will average less than 2 percent. Households and businesses will come to expect this result, meaning that inflation expectations would tend to move below our inflation goal and pull realized inflation down."

- *This rationale explains the asymmetry implicit in the new strategy – business cycle recessions will take care of the downside in inflation, and policy will take care of the upside.*
- This move was widely expected. It's been kicked around forever. Former chair Janet Yellen, who liked to use fancier terminology, used to call it "optimal control" (see "It's Yellen's World, and We're Just Living In It" June 18, 2014).
- We were skeptical that Powell would make this change at this time, perhaps not wanting to rock the boat with any fundamental changes when the economy is still so fragile. Maybe after so many FOMC press conferences and congressional appearances at which he is always interpreted as being pessimistic, going ahead with this was his way of demonstrating confidence. Or maybe he just thought this was a way of "doing something" – even after he has done so much already, and with the Fed's massive new lending facilities utilized at less than 10% of capacity (see "On the Fed's Massive Intervention" March 23, 2020).
- *Obviously, any statement of policy objectives begs the question of whether they can actually be carried out. It's not like the Fed hasn't had a inflation target of 2% all along – and try as they might, they and all the other central banks in the world have missed for more*

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On the web at
trendmacro.com

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Donald Luskin
Dallas TX
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

than a decade (again, please see that chart on the first page).

- *That said, we are constantly asked by clients whether the latest round of global central bank accommodation, along with various rescue and stimulus efforts by the treasuries of the world, won't be sufficient (once the economy recovers more) to finally trigger some inflation, perhaps even too much*. They have already been sufficient to arrest US deflation from the global virus lockdowns. The Consumer Price Index ex-energy peaked in February, and troughed just three months later down a mere 0.14%. Already, since June, it is at new all-time highs.
- *So the Fed may soon be put to the test to see just how much of an overshoot it will tolerate, and what will happen when that tolerance runs out at some unknown informal level. Powell said in his speech this morning that "if excessive inflationary pressures were to build or inflation expectations were to ratchet above levels consistent with our goal, we would not hesitate to act."*

Bottom line

Powell announces a new policy framework in which inflation will be allowed to run above the target of 2% after a period in which it was below target. It is asymmetrical – there is no commitment to run inflation below target after a period above target. There is no specific formula for levels or duration of inflation overshoot. This was broadly expected. It means the Fed will let the economy "run hot," definitively burying the growth-killing Phillips Curve and "automatic pilot" nonsense that marred Powell's first year as chair. With so much relief and stimulus in the economy, deflation has already been arrested after just three months and a tiny CPI dip. A rise in inflation may soon put the Fed's new framework into action – or, rather, inaction.