Retirement Income
JOURNAL

Shadow-Boxing with the Fed

By Tim Duy *Thu, Dec 10, 2020*

The Fed is giving mixed messages: Telling investors to relax while telling Congress to take fiscal action against the pandemic slump. Our guest columnist interprets the oracle.

In the wake of the less-than-spectacular (though I think underrated) November employment report, research shops are telling clients that the Fed will most certainly shift the pattern of asset purchases toward the longer end of the yield curve.

I find this position curious. Fed speakers have said both implicitly and explicitly *not* to expect changes to the asset purchase program at this next Fed meeting. From my perch, there appears to be a communication error in the making.

That said, I will lay out (again) the case for additional Fed easing as well as the alternative (and, I think) more likely scenario. Here are the prominent elements of the Fed's recent communications:

First: The Fed wants to emphasize it is not considering raising interest rates. This is fairly straightforward. The Fed does not want to repeat the mistakes of the last cycle and engender expectations of policy normalization.

Second: The Fed's new strategy suggests that public comments from FOMC participants will have a downward forecast bias, particularly in the near-term. In one of my classes, we do an exercise where a forecaster has an asymmetric loss function; errors on one side of the forecast cost more than errors on the other side. As a consequence, the forecaster should bias their forecast to minimize the odds of an error on the "wrong" side of the outcome distribution. The Fed has explicitly adopted an asymmetric loss function in its policy framework:

> Owing in part to the proximity of interest rates to the effective lower bound, the Committee judges that downward risks to employment and inflation have increased.

The rational thing to do when you have such a loss function is to emphasize the downside risk. In other words, when making policy considerations, the Fed is biasing its forecasts down to mitigate the risk associated with being close to the effective lower bound.

This supports an excessively pessimistic public position in which the Fed will say more policy support is likely needed–even if an unbiased forecast says no such support is needed. This will encourage market participants to expect easing even if no reasons for it exist.

Third. The Fed is “woke.” The Fed has long ignored the micro-consequences of its actions, preferring to focus on the macro story. This focus has led the Fed to embrace the risk of higher unemployment in order to reduce the risk of inflation—even though the latter hasn’t been a problem. With the help of the ‘Fed Listens’ events, the Fed now understands how it inadvertently contributed to high unemployment. The Fed now reminds us that it has learned from its errors with comments such as this from the minutes:

> Many participants observed that high rates of job losses had been especially prevalent among lower-wage workers, particularly in the services sector, and among women, African Americans, and Hispanics. A few participants noted that these trends, if slow to reverse, could exacerbate racial, gender, and other social-economic disparities. In addition, a slow job market recovery would cause particular hardship for those with less educational attainment, less access to childcare or broadband, or greater need for retraining.

This language, while accurate, contributes to a perception of negative bias in the Fed’s outlook. Note also that while some of these problems are cyclical (a persistently strong job market will help alleviate the stress on lower-wage households), many are structural. Even with a strong job market and fiscal policy fixes, they won’t entirely go away.

The Fed can’t fix everything. It will be interesting to see how it explains pulling back on policy when these issues haven’t been resolved.

Fourth: The Fed wants more fiscal support for the economy. Rightly, in my opinion, it believes the economy’s immediate problems require a fiscal rather than a monetary response. I believe the Fed’s oft-stated concerns regarding the near-term outlook have more to do with maintaining public pressure on Congress to act rather than signaling a monetary policy response. Market participants, however, might interpret the Fed as indicating it will attempt to compensate for a failure by Congress to reach a compromise on fiscal policy.

Fifth: The Fed insists that its tools remain effective and that it will use all of them to support the recovery. Vice-chair Richard Clarida recently said:

> These large-scale asset purchases are providing substantial support to the economic recovery by sustaining smooth market functioning and fostering accommodative financial conditions, thereby supporting the flow of credit to households and businesses. At our November FOMC meeting, we discussed our asset purchases and the critical role they are playing in supporting the economic recovery. Looking ahead, we will continue to monitor developments and assess how our ongoing asset purchases can best support achieving our maximum-employment and price-stability objectives.

This suggests that the Fed believes that it can turn up the dial on asset purchases to accelerate the recovery. But that's wrong.

Sixth: The Fed is increasingly aware of the medium-term upside risks to the forecast, but often downplays those risks. Chair Jerome Powell, for example, in recent testimony that news on the vaccine front is very positive for the medium term. But market participants can be forgiven if they don't focus on that point. Neither can Powell, because the above points force him back to the near-term risks:

> For now, challenges and uncertainties with respect to the vaccine remain, including timing, production and distribution, and efficacy across different groups. It remains difficult to assess the timing and scope of the economic implications of these developments with confidence.

Altogether, the Fed's messaging dwells on the imminent downside risks to the economy. It feels a need to avoid anything that might sound like it intends to revise the path of interest rates. It's saying that the economy needs more support, and that it has the tools to support it.

Bottom Line: I have no secret source telling me what will happen next week. I understand the belief that more easing is coming. But I don't like to predict the opposite of what multiple Fed speakers are saying. The Fed seems to be saying that it will go after the low-hanging fruit by issuing some guidance on the asset purchase program at the next meeting.

In November, the Fed did discuss potentially changing the duration mix or the size of asset purchases. But that discussion regarded policy beyond the current surge of COVID cases.

With financial conditions currently easy and the Fed unable to impact near-term economic outcomes, it has no reason to change policy next week. Of course, the Fed could address any unexpected tightening of financial conditions between now and the meeting.