LINDSEY M. PIEGZA, PH.D.
CHIEF ECONOMIST
(312) 454-3873
PIEGZAL@STIFEL.COM

Fed Maintains Accommodative Posture

Keeps Remaining Policy Tools in Reserve

At the latest FOMC meeting, the Federal Reserve opted to keep rates steady in a range of 0.00% to 0.25%, as they have since March. The Fed, furthermore, recommitted to maintaining the numerous liquidity and lending programs put in place at the onset of the pandemic and the current pace of $120 billion per month in asset purchases. In other words, aside from a renewed push for fiscal support, and despite some monetary tools still available for further economic support, policy was broadly kept unchanged.

In the Fed's September statement, officials attempted to walk the fine line between patting themselves on the back for the policies already implemented, crediting the Committee with stemming a more dire economic contraction in Q2, with ongoing risks to the market. After all, the economy has *"picked up"* and financial conditions have improved, reflecting, as the Fed says, measures the central bank implemented to support the economy – but risks remain.

Despite modest gains, the U.S. economy is far from a position of outright strength. The labor market for example, has created 10.6 million jobs since May, but 12 million Americans still remain out of work. From a consumption standpoint, while monthly spending on an annual basis has been trending positive since May, total expenditures are down 2.8% and off more than 5% since the start of the year. And, while manufacturing has moved back into positive territory, up from a low of 41.5 in April, business investment is off nearly 20% from this time last year. Thus, while the Fed is no doubt justified in celebrating the vast improvement in activity from the low, low… low levels posted throughout the spring, there are still considerable gains needed to be made before the economy is on solid footing, let alone back to pre-pandemic levels – which may never be achieved, at least not organically.

At this point, with the economy in need of additional support, the central bank may have little more to offer; over the past six months amid an unprecedented policy approach to stem the impact of the virus-induced shutdown, monetary policy officials appear to have used the vast majority of the tools in their tool belt, at least the traditional options and their derivatives. Since lowering the federal funds rate from 1.75% to 0.25% in March, the Committee has since jumpstarted asset purchases, and launched a series of lending and liquidity programs. Combined, these initiatives have pumped trillions of dollars into the economy.

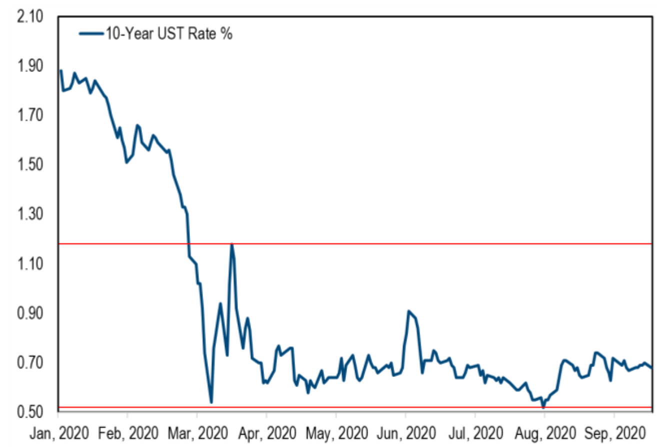
With just a few arrows left in its quiver, the Fed has now chosen, at least for the time being, to hold steady and keep its remaining policy options in reserve. When the time is right, the Fed could, for example, offer even more explicit forward guidance. In September, the updated statement offered *"enhanced forward guidance"* that more clearly ties further policy adjustments to economic outcomes. The conditions, however, outlined in the statement were somewhat vague, offering the Fed its usual and longstanding ambiguity around a timeline for raising rates. The Fed has been clear about its intentions to keep rates at an accommodative level for years to come, however, even with new, additional forward guidance, when it comes time to push rates higher, the Committee may still be able to find a reason – or two – to delay.

Source: Bloomberg, Haver Analytics

The Fed could also continue to ramp up asset purchases. Last Wednesday, the Fed committed to continue asset purchases at a pace of roughly $120 billion – $80 billion in Treasuries and $40 billion in mortgage securities, net of maturing bonds, on a monthly basis. Beginning at $4.2 trillion, the Fed's balance sheet has already swooned to $7 trillion with over $2.5 trillion in purchases since March. Going forward, with another six months to a year of accelerated purchases, the end size of the Fed's balance sheet could reach $8 or $9 trillion, maybe more.

Of course, growing the balance sheet is nothing new. In 2008, the Fed launched a series of purchase programs that fueled rallies in assets from equities to real estate. A total of three rounds, each worked to lower interest rates along the curve – or in the case of QE3, slow the pace of increase. More recently, rates have held steady within a very narrow range, less than 20bps off all-time lows.

The Fed could also reintroduce yield curve targets. Unlike quantitative easing, that can act to lower rates, under yield curve control the Fed explicitly declares its target for long-term rates. Of course, the purpose of lower rates in either case is to further incentivize the private sector to borrow and by extension, jumpstart the economy. This time, however, the Fed is already lending money directly to borrowers so the primary benefit of further explicit control would arguably be to make the federal debt more manageable.



Source: Bloomberg

Coupled with a longer-term inflationary risk, Fed officials have been reportedly reluctant to implement yield curve targets, a policy which could be difficult, or could be seen as potentially difficult, to terminate. Other central banks, however, have found the policy more appealing. The Bank of Japan has used yield curve control to target 10-year government bonds around zero percent since 2016. On the shorter end of the curve, the Bank of Australia announced a target for the yield on 3-year government bonds of around 0.25 percent in March. And in July, Bank of Canada Governor Tiff Macklem said yield curve control was being discussed by policymakers, although nothing has been announced as of yet.

Despite unprecedented action already taken in the U.S., the Federal Reserve still has a handful of tricks up its sleeve – even if it's closer to Grandpa's magic of pulling a quarter from behind the ear, as opposed to a more impressive sleight of hand such as sawing a woman in half. But for now, while committed to supporting the recovery by any means necessary, rather than opt for further action – however unimpressive – the Fed has decided to take a step back to the sidelines. Pleased with its current position, the Fed has repeatedly affirmed a commitment to deploy any money or credit needed to keep markets functional, passing the proverbial support baton to officials in Washington.

-Lindsey Piegza, Ph.D., Chief Economist

Glossary
FOMC – Federal Open Market Committee
QE – Quantitative Easing