Chart of the Month

September 2020

Federal Reserve Chairman Jerome Powell announced a major shift in the central bank's monetary policy at the annual Jackson Hole symposium last Thursday. The Federal Market Open Committee unanimously approved a new strategy designed to target an *average* inflation rate of 2% rather than a *limit* of 2%, which means it will tolerate inflation rising moderately above its objective to compensate for periods of time when it has run below its goal.

While the change may seem subtle on the surface, it has important implications for the financial markets. The key takeaway is that the Fed will be slower to raise interest rates in the future, even in the face of an improving economy and jobs market. Allowing inflation to run "hotter" than normal should boost economic growth and corporate profits.

An extended period of low interest rates is likely to favor, in order, (1) growth stocks because the discounted value of future earnings are worth more in a virtual zero-interest-rate environment, (2) dividend-paying stocks with a history of increasing their payouts, (3) well-positioned real estate investment trusts, and (4) corporate bonds. All of these assets should outperform government bonds, CDs, and money-market funds, albeit with more volatility and risk.

Although stocks are expensively priced relative to historical valuations, they are "ridiculously cheap" in the words of Warren Buffett in May 2019 when the 30-year Treasury was nearly 3%. The yield on that bond is 1.48% today, roughly half of where it was back then.

The Fed still believes that a longer-run inflation rate of 2% is most consistent with its dual mandate to promote both maximum employment and price stability. However, the central bank now believes that "a robust job market can be sustained without causing an outbreak of inflation," which has mostly ranged between 1.20% and 2.10% over the past 10 years with an average of approximately 1.60%. The core rate for July was 1.25% or 0.75% below the target. As shown in the chart below, the rate has only risen above 2% twice in the last 10 years.

The Federal Open Market Committee is scheduled to meet on September 15 and 16. While not expecting Powell to add another "thinking about" to his "not even thinking about thinking about thinking about raising rates" to his statement, we believe the Chairman will reconfirm the Fed's commitment to low interest rates for years to come.

Personal Consumption Expenditures Price Index 2010-2020

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