Inflation War Stories: The Fed Charts a New Strategic Framework

The Bank of Japan has failed to reach its inflation target for decades—is the Fed heading down a similar path?

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Prepare for the "K Economy"

As we highlighted in July, fiscal support is a critical component of the economic recovery. Despite several failed attempts by Congress to reach agreement on a new round of fiscal stimulus to support the pandemic-stricken economy, markets have remained relatively relaxed as most market participants share our view that additional stimulus will ultimately come to fruition. However, in the meantime, a risk we highlighted earlier this year is becoming more apparent: There will be lingering damage on consumers in lower income brackets.

Prior to the COVID-19 pandemic, consumers on the lower end of the income bracket were in good shape primarily because of low unemployment (which provided cash flow liquidity), not necessarily because of asset growth or declining leverage. Consumers on the higher end of the income bracket have largely kept their jobs and adapted to the pandemic by working from home. On the other hand, consumers on the lower end of the income bracket have relied primarily on stimulus provided by the federal government as jobs in lower paying segments of the labor market like leisure, lodging and retail have been eliminated or furloughed and yet to return. In these areas of the market, the high contact intensity is the driver behind the job losses, as consumers' fear and government regulations that limit capacity have reduced demand, in some cases dramatically.

Against this backdrop, the pandemic is creating a "two-speed" recovery between consumers on opposite ends of the income bracket. Similar to consumers, the fundamental outlook across corporate sectors is also fragmented. We see the U.S. economy shifting into a "K-shaped" recovery defined by uneven pressures that will create winners and losers with broad strokes across asset classes, sectors, and investment styles.

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Figure 1. "K Economy" Creates Winners and Losers

Source: Voya Investment Management. For illustrative purposes only.

The Fed Plays the News Cycle: A Historic Change Garners Little Attention

In contrast to the current gridlock among fiscal policy makers, the Federal Reserve is doing all it can to foster a vigorous revival in growth. In fact, while much of the headlines and attention have focused on the lack of additional fiscal stimulus, we believe the more significant story from a long-term perspective is the new strategic framework outlined by the Fed. Going forward, Fed policy will be informed by assessment of the "shortfalls of employment from its maximum level," whereas the Fed's original language referred to "deviations from its maximum level."

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The Federal Open Market Committee (FOMC) has also adjusted the approach to its longer-run inflation goal of 2%, now seeking to achieve inflation that averages 2% over time. After periods of persistently low inflation, the FOMC would tolerate inflation moderately above 2% "for some time," to allow the economy to solidify a recovery. The updated strategy also acknowledges the challenges of a persistently low interest rate environment, in which policy rates alone have limited potential to benefit the economy.

The background for these changes by the Fed suggests that labor income distribution issues will have greater influence on FOMC policy decision-making. Over the long term, this could result in longer periods of accommodation than might otherwise be expected during economic recovery phases.

Is the United States Becoming Japan?

The Fed's adjusted approach to inflation has invoked comparisons to Japan, a country that has been battling a disinflationary environment since the 1990s. Sceptics often argue that the Bank of Japan's failure to achieve its inflation target over several decades is evidence that a central bank's ability to generate inflation is very limited. However, a closer look at Japan reveals a more nuanced story and provides valuable lessons for United States on the path ahead (lessons that U.S. policymakers seem to be heeding—at least so far).

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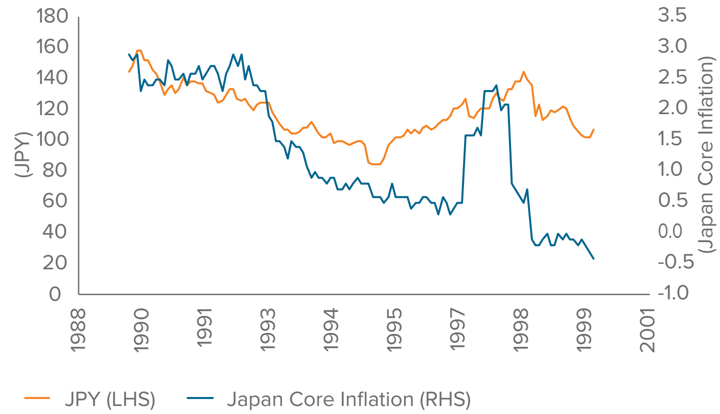
Japan's experience of stagflation during 1970s caused the BOJ to hesitate and stop short of implementing fully accommodative policy. As Figure 2 highlights, even though the BOJ eased in the 1990s, the Japanese Yen kept strengthening. The Fed, on the other hand, has adopted a Zero Interest Rate Policy and announced that it will keep rates near their historic lows until at least 2022. In other words, unlike the BOJ in the 1990s the Fed has been decisively committed to keeping monetary policy as accommodative as possible.

Figure 2. The relationship between the Yen and inflation is a reminder that the BOJ was too slow to implement accommodative monetary policy

10 years since bubble bust in Japan

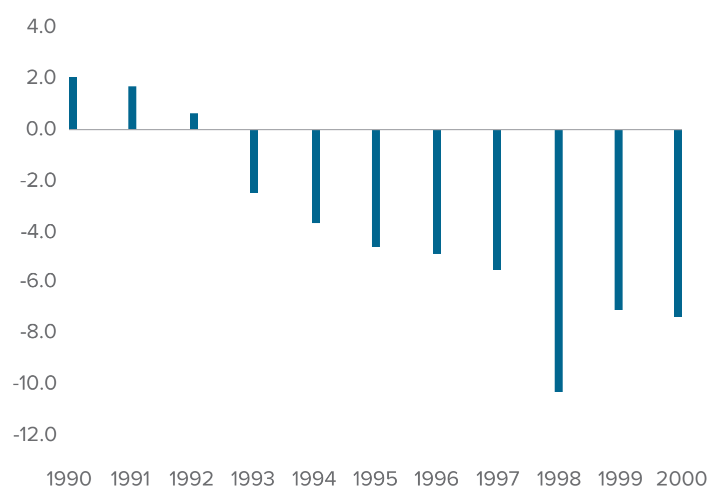


1990 –2000. Source: Bloomberg and Voya Investment Management.

As Figure 3 shows, the Japanese government also held back on stimulus. Not only did the government wait until 1993 to introduce stimulus, the initial stimulus was minimal (resulting in only a 2% deficit). While policymakers in the United States are grappling over additional stimulus, the response since the pandemic has still been enormous. U.S. government spending has already resulted in a deficit of more than 20% and the expectation is that the deficit will remain in double digits in the years to come.

Figure 3. Japan's fiscal response was too little too late

Budget Deficit in Japan

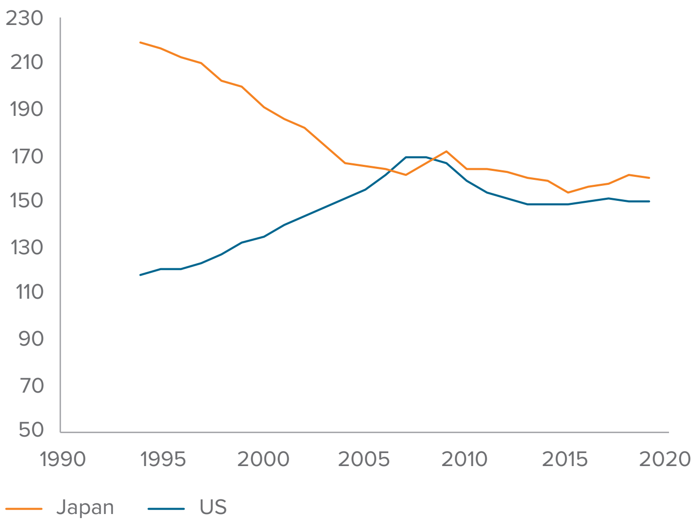


1990 – 2000. Source: Bloomberg and Voya Investment Management.

There is another key difference between the United States and Japan. In Japan, the level of debt was unprecedented going into their crisis. In the 1990s, the private sector in Japan kept deleveraging, which made monetary easing ineffective, i.e. a "liquidity trap". In the U.S. the starting point is much better and deleveraging has largely come to an end (Figure 4).

Figure 4. The U.S. is better positioned to avoid a "liquidity trap"

Non financial Private Debt to GDP



1994 – December 31, 2019. Source: IMF and Voya Investment Management.

How to Prepare Portfolios: Is Value Dead?

As we highlighted earlier, we see the U.S. economy shifting into a "K-shaped" recovery. The resulting uneven pressures will create winners and losers with broad strokes across markets.

At a high level, U.S. equities, large and small, remain our favorite asset classes. The U.S. market's sector composition – heavily weighted with technology and healthcare companies – has helped buffer some of the hit to earnings experienced through the COVID recession. Because of business models that are relatively resilient to the steps being taken to combat the coronavirus spread, we think these firms, particularly the large caps, will continue to gain the upper hand throughout the pandemic and during the early post-COVID period. In addition, small cap equities also provide more cyclical exposure and should perform well as the economy continues to heal and activity perks up.

While this dichotomy is true at the asset class and sector level, it is also true for investment style, as the Fed's adjusted stance on inflation and unemployment could have longer-term implications for the "growth versus value" debate in equities. As illustrated in Figure 5, history has shown that we need both real rates to be off their lows and inflation to be expected to pick up for value to deliver outperformance. With this in mind, equity investors can add some value exposure to their portfolio for diversification, in case the Fed is successful and the long-standing leadership of growth stocks may come to an end.

Figure 5. Value has thrived when real rates are off their lows and inflation is expected to pick up

Average monthly value premium, by real rate and break-even inflation regime

		break-even inflation rate			
		< 2%	2 - 4%	> 4%	any
real rate	< 1%	-0.43	-0.34	0.67	-0.15
	1 - 2.5%	0.29	0.25	0.14	0.21
	>2.5%	0.04	0.85	0.72	0.59
	all	-0.09	0.36	0.47	0.26

April 1959 - August 2020, in percent; real rate and break-even inflation estimated at 5 year tenor

Source: Fama-French data library, Bloomberg, and Voya Investment Management

In fixed income, security selection, which is always important, has become absolutely critical as the dispersion between "winning" sectors and "losing" sectors (and winners and losers within those sectors) is extremely wide. While the fixed income markets have staged a dramatic recovery since April, there are still opportunities to prepare portfolios today for the low-yield world ahead. Longer term, in an income starved world that has experienced historic re-leveraging in corporate credit, we continue to favor securitized credit over corporate credit. Drilling into securitized credit, we are finding the most attractive long-term opportunities in the commercial mortgage-backed securities (CMBS) sub-sector, which has yet to see the "V" shaped recovery of other fixed income segments. Risk has clearly increased in CMBS, but 6+ months into the pandemic, fundamental impacts are much clearer while market efficiency is not—this is creating opportunities to prepare portfolios for the low-yield world ahead.

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