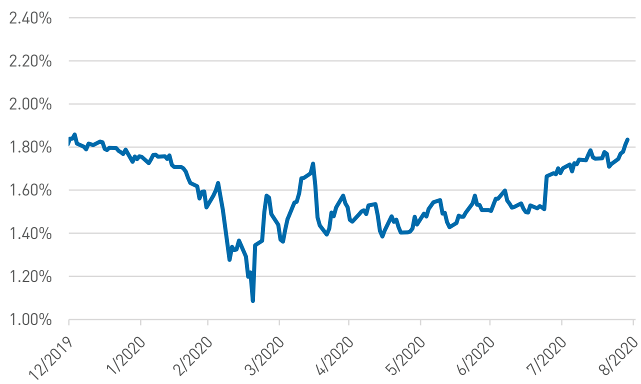
MY HERO, ZERO...NOW YOU'RE HERE TO STAY

SEPTEMBER 2020

Since the Global Financial Crisis (GFC), the Federal Reserve (Fed) has occasionally used its annual Jackson Hole symposium to preview changes in monetary policy. Over the last two months, financial markets began to anticipate Chair Jerome Powell would address the Fed's dual mandate of full employment and price stability during his speech on August 27 (the meeting was held virtually this year due to COVID-19). In particular, the market appeared to expect a willingness by the Fed to allow inflation to overshoot its long-term 2% target, as we've witnessed a recent steepening in both the inflation breakeven and nominal yield curves (Charts 1, 2).

Chart 1

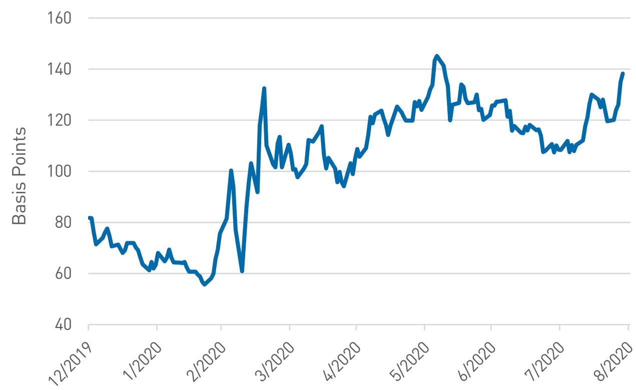
5-Year, 5-Year Forward Breakeven Inflation Rate



Data from 12/31/19 to 08/28/20. Source: Bloomberg L.P., PNC Capital Advisors

Chart 2

Spread Between 2-Year US Treasury Note and 30-Year US Treasury Bond



Data from 12/31/19 to 08/28/20. Source: Bloomberg L.P., PNC Capital Advisors

As expected, Chair Powell outlined several updates to the Fed's framework, which was informed by both its internal research and a series of *Fed Listens* events around the country (as Powell outlined in his speech, the *Fed Listens* events were aimed at broadening the Fed's perspective and engaging the public "as is appropriate in our democratic society"). This work led the Federal Open Market Committee (FOMC) to codify changes through unanimous approval of a revised "Statement on Longer-Run Goals and Monetary Policy Strategy."[1] Notable changes to the framework include the following:

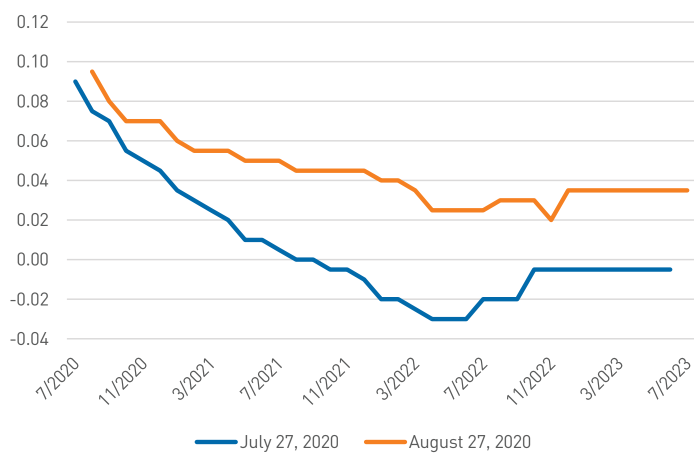
With respect to employment, the FOMC emphasized a broad-based and inclusive goal that assesses "shortfalls of employment from its maximum level." Previously, the focus was on "deviations from its maximum level."

Regarding price stability, the FOMC moved towards a symmetric goal targeting longer-run inflation of 2% by seeking "to achieve inflation that averages 2% over time."

This updated framework is a reflection of the low interest rate environment, both domestically and globally, that has persisted since the GFC. By implementing these changes, we believe the FOMC is acknowledging that reliance on the traditional policy tool – the fed funds rate – will likely be constrained. While this suggests the fed funds target range will remain at or near the effective lower bound for an extended period, the announcement has helped alleviate market pressure that resulted from speculation about the

Chart 3

Fed Funds Futures Curve (Rate)



As of 08/28/20. Source: Bloomberg L.P., PNC Capital Advisors

1 - "Statement on Longer-Run Goals and Monetary Policy Strategy." Federal Reserve (August 27, 2020). https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-statement-on-longer-run-goals-monetary-policy-strategy.htm

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possibility of negative rates in late 2021/early 2022 (Chart 3).

Most importantly, in our view, is the impact of the subtle shift in the employment mandate, which brings into the Fed's calculus many of the socioeconomic imbalances that have been cast in stark relief by the pandemic. As Chair Powell outlined in his speech, the "change reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities." Indeed research from the Pew Research Center earlier this year indicates a widening gap between upper-income households' share of aggregate income (approaching 50%) and middle/lower-income households. Wealth concentration is even more pronounced, with upper-income households accounting for almost four-fifths of the US aggregate.[2] We expect the Minneapolis Fed's Opportunity and Inclusive Growth Institute, established in early 2017, will continue to be instrumental in supporting the broader Fed's efforts through its research focused on supporting "economic opportunity and inclusive growth for all Americans." We hope this will be an important step down a long path to address the economic and wealth disadvantages prevalent across the United States, in part attributable to systemic racism.

Market Implications

It is clear the Fed stands ready to support the economy through both traditional and unconventional policy tools for the foreseeable future. Since the GFC, macro and structural issues have created persistent headwinds for the Fed's efforts to achieve its inflation objective on a consistent basis. While these headwinds are unlikely to abate, we expect the announced policy changes should – all else equal – result in a steeper yield curve, higher inflation expectations (as measured by Treasury Inflation Protected Securities breakeven spreads), and a lower US dollar, supporting investor risk appetites. While well off its peaks, the global balance of negative yielding debt still approximates $14 trillion and likely limits the potential for US interest rates to rise materially despite a more dovish Fed – much to the dismay of the bond vigilantes of yore.

2 - "Trends in U.S. Income and Wealth Inequality." Pew Research Center, Washington D.C. (January 9, 2020). https://www.pewsocialtrends.org/2020/01/09/trends-in-income-and-wealth-inequality/