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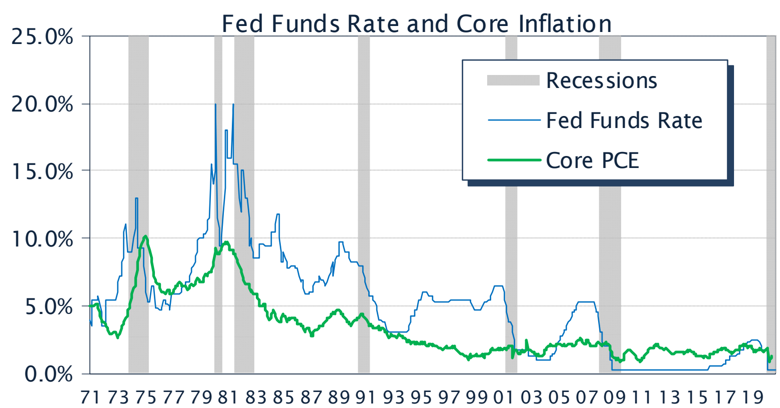
Agincourt Capital Management, LLC

INVESTMENT UPDATE

On August 27th, at its annual Jackson Hole conference (held remotely this year), the Federal Reserve announced significant changes to its monetary policies, tossing out a big chunk of the framework that had been in place for four decades. We'll look at these new policies in detail this month, but the short version is that the Fed's focus going forward will be more tilted towards promoting economic growth and less on fighting inflation. This is a big deal, and could have a measurable impact on interest rates and bond prices in the years ahead.

As always, let's review a little history. Since the 1970s, the Federal Reserve, in addition to its regulatory duties, has been charged with a "dual mandate": to guide the US economy towards price stability and full employment. "Price stability" is important because a low and predictable rate of inflation makes decision-making easier for both businesses and households, providing a stable environment for budgeting for future purchases and protecting the value of fixed income investments. "Full employment" is likewise a valuable goal, as policymakers want an economy that's generating employment opportunities for everyone who wants a job.



Naturally, there's a bit of give-and-take when it comes to these two goals—a strong and fast-growing economy may provide abundant demand for jobs, but high demand for jobs could result in labor shortages. That, in turn, may lead to increased competition for fewer available workers, who can now demand higher wages, which results in higher costs for businesses. Higher production costs will then be passed on to consumers, pushing inflation higher and violating the mandate to keep prices stable. This is what economists call "cost-push" inflation, when a strong economy creates shortages—and higher costs—of necessary inputs of production.

In the 1970s and 80s, the US economy consistently bumped up against shortages in raw materials—including labor—during the expansion phase of each cycle. Worse, we were far more vulnerable to increases in crude oil prices; OPEC was particularly strong then, with the capacity to bring economic growth to a crawl, sending gasoline prices sky-high when it imposed supply cuts. "Stagflation" was in full effect, as successive recoveries were snuffed out by ever-higher inflation cutting into consumer spending.

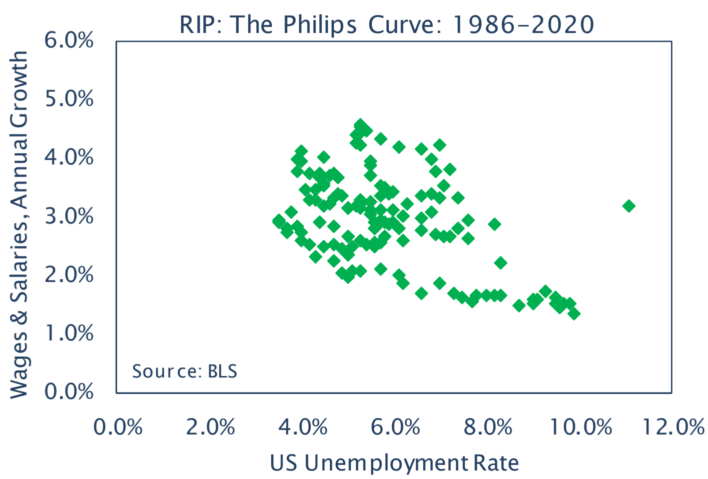
In 1977, hoping to control the rate of inflation and smooth economic growth, Congress passed the Humphrey-Hawkins Act, which codified the Fed's dual mandate. A few months after the bill was signed in early '78, Paul Volcker was appointed as the Fed's new chair. Volcker got to work quickly, and by mid-1979, with inflation rising towards 10%, the Fed aggressively pushed up its overnight funds rate, finally peaking at 20% in early 1980. Volcker's tough inflation-fighting sent the economy reeling, with a double-barreled recession that ran (with a brief pause) for nearly three years.

As the chart on this page shows, since that period of double-digit Fed funds rates, inflation has steadily fallen, with the core PCE (the Fed's preferred measure of inflation) averaging just 1.7% since the mid-1990s. Interest rates have fallen along with inflation, providing excellent returns for bond investors, while helping to boost equity valuations and home prices. A job well done, right?

Well, not exactly. And that's because the world is very different today, economically speaking, than it was in 1980, due to two main factors: globalization and demographics. The opening up of developing economies, and the easy movement of capital around the globe today, provides a ready supply of relatively cheap labor—not just for manufacturing jobs, but for outsourced service jobs as well. Sophisticated supply chain and inventory management has made other inputs of production available on-demand, further increasing competition and reducing the price of doing business. Technology advances in energy production (e.g., fracking and shale oil extraction) have made the US far more energy independent, keeping energy prices down even during periods of high demand, and significantly curtailing OPEC's pricing power.

Meanwhile, over the past four decades, every developed economy has undergone significant demographic changes, with aging populations and falling birth rates. With more retirees and relatively fewer people in the fast-spending 30-to-50 demographic, growth in demand for goods and services has slowed since the 1980s. Perhaps even more importantly, slower labor force growth has meant that baseline US GDP has tapered off, despite good increases in productivity among US workers. After growing at an average annual rate of 2.7% in the 70s and 80s, US real GDP has grown by less than 2% per year over the past 20 years.

Despite the significant changes in the world over the past few decades, the Fed had been holding fast to many of the same tools, models, and biases that had become literally institutionalized among the staff and policymakers at the Fed. None has shown less rigor over the years, while at the same time remaining an essential guiding principle for the Fed, than the so-called Phillips Curve, which posits that inflation and unemployment are inversely related. The Fed has long had a policy of raising rates when the economy approached "full employment," believing that wages (and thus inflation) would have to rise. But as the chart on this page makes clear, since at least 1986, there has been virtually no relationship (except at very high rates of unemployment, when wages fall off) between these two economic measures. At unemployment rates between 3% and 8% (its range in approximately 90% of these observations), the pattern is not just non-linear, it closely resembles a shotgun blast.



Instead of replacing these models, over the past few years the Fed has consistently made excuses for them, or tried to tweak them to fit what was actually happening in the real world, all the while pressing forward with the same tough anti-inflation policies. Again and again (as recently as 2018-2019), the Fed stepped in and snuffed out growth in the late stages of economic expansion in anticipation of inflation that never seemed to materialize. As a result, inflation expectations (and interest rates) fell in each subsequent cycle, culminating in the Fed having to move to a near-zero interest rate policy for much of the past decade. And yet—importantly—behind the scenes, researchers at the Fed over the past few years have been pushing for change, and studying ways to implement more sensible, up-to-date monetary policies that would acknowledge the massive structural changes in the global economy over the past 40 years.

Which brings us to the implementation of what the Fed calls its revised "flexible average inflation strategy." It's flexible in that it won't be tied to any particular model or formula, and will place its emphasis on the goal of full employment rather than low inflation. Operationally, the Fed will not be as quick to pull the trigger on rate hikes, allowing the economy to "run hot" longer and deeper into the economic cycle. If inflation, as anticipated, rises above the 2% inflation target, that will be acceptable for a period of time roughly equal to the time inflation clocked in below 2% during that cycle. Thus, inflation will truly average 2% over time. With inflation expectations anchored at a slightly higher rate, this policy will help move the Fed away from flirting with negative interest rates when the funds rate is at the "zero lower bound," a constraint the Fed is eager to shed.

To be clear, with the US and global economies currently struggling to generate any positive economic momentum, this change in policy won't come into effect anytime soon. As we discussed last month, the US economy is expected to operate well below its potential for the better part of the next decade; the COVID pandemic makes economic projections even more difficult. But it's safe to say that over time this policy change will result in slightly higher inflation, and should lead (all things being equal) to a steeper yield curve, with short rates being held down longer, and longer rates rising to reflect the increased inflationary risks. For bond investors, it's a mixed bag; there is likely to be a slow increase in rates over time, but that will eventually lead to higher baseline rates across the maturity spectrum, which will improve prospective returns for bondholders over the long term.

The Fed has also mentioned that stronger late-cycle economic growth will help reduce income disparity, as research has shown that the most economically-challenged neighborhoods and populations benefit most during the later stages of the cycle, when labor markets are most stretched. In this regard, the Fed finds itself on the side of social activists, who have complained for decades that the Fed's tough anti-inflation policies curtail employment opportunities for many working-class households. High levels of wealth disparity have historically been associated with elevated social unrest; from a purely economic standpoint, we should all be in favor of policies that serve the broader interests of society.

For the Fed, these policy changes have been a long time coming, and, despite some additional uncertainty, are a big step in the right direction in bringing its policies into the 21st century.