Average Inflation Targeting

By Alejandro Palacios

In the last week of August, the Federal Reserve announced a major policy change saying that they will allow inflation to fluctuate more freely than before, differing from their past strategies to cope with inflation. Before, the Federal Reserve set inflation targets and coordinated monetary policy accordingly to meet their goal. The inflation target since the late 1990's usually has been 2% , however, they will now allow an inflation overshoot in order to stimulate economic growth. This should not come as a surprise for investors and economists as it is not the first time. The way the Federal Reserve used to achieve a 2% inflation per year was through the use of its fed funds rate as a way to 'cool' the economy. As the Federal Reserve raises its rates, banks must do the same meaning that the cost of borrowing increases. This means that less people will take out loans borrow money from banks which reduce the amount of spending and money in circulation putting a downward pressure on prices. Currently, the fed funds rate is nearly zero which means that the Fed is out of ammunition to combat inflation. In order to keep the economy and stock market afloat during the recession caused by the pandemic, The Federal Reserve aggressively increased the supply of money through quantitative easing. ts effect can be clearly seen by the dissociation of stock market prices rising to almost new highs while the real economy has experienced a slow rebound. Theoretically, the increase in money supply would not be a problem if growth in real output was equal. The reality is, that economic growth has been slow and the fed's balance sheet has skyrocketed drastically. Hence, the increase in supply will have to be met with an increase in monetary demand causing prices to increase causing inflation.

The Federal Reserve's decision to adjust from a fixed inflation target to an average inflation targeting strategy tells us not only that they are running out of ways to keep inflation stable, but it also tells us that keeping inflation fixed at 2% is costly and would harm economic growth in the long term. Letting inflation overshoot over an extended period of time will stimulate growth and have more beneficial impacts so long as there is a steady rise in economic growth.

Now established that the world will not end because of the Federal Reserve's change in coping strategy towards inflation, how will it affect markets? Below I provide you with three expectations I have for the future.

Firstly, the Fed's decision means that rates will remain low in the future: and interest rates on other financial securities such as Certificates of Deposit and short-term treasuries will remain near zero. This will cause more savers and retirees to allocate larger parts of their portfolios in equities as they try to compensate the lack of returns these 'safe' securities used to provide. Moreover, leverage and margin costs will remain very low allowing investors to boost their returns and therefore increasing the money being thrown into the equity sector.

Secondly, low interest rates can be a bullish sign to real estate prices. Now that individuals can borrow money from banks at low interest rates, they can afford more expensive homes and renters can now opt to buy a home instead of renting. The most recent housing figures show that as of July 2020 house sales surged to a record 24.7% which marks the second consecutive month of record sales. Meanwhile, this surge comes at a time where real estate inventory is short. The supply of existing

homes plummeted to 21.1% annually. All the above is resulting in a surge in US home prices. The housing market sits in the perfect storm and it will not be rare if we find ourselves in a new housing boom.

Finally, the chase for yield will continue in the future. Before, retirees planned for a 3% to 5% return from a 10-year treasury yield. Now, it is closer to 0.7%. Although treasury yields have fallen investors are still looking to provide the same of return to its clients and will look to allocate some of their capital into high-dividend stocks and other high yield-bonds which are currently undervalued.

I would like to conclude with one final observation. I have been very optimistic with my outlook about the Fed's new strategy to fight inflation. Yes, it will benefit markets, and investors will change strategies in order to adjust from the lack of yield safe securities used to offer. Unfortunately, the increase in the supply of money will detrimentally affect the lower spectrum of the income ladder if the government fails to reduce the income inequality gap and provide proper economic assistance.