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The Fed and Max Q

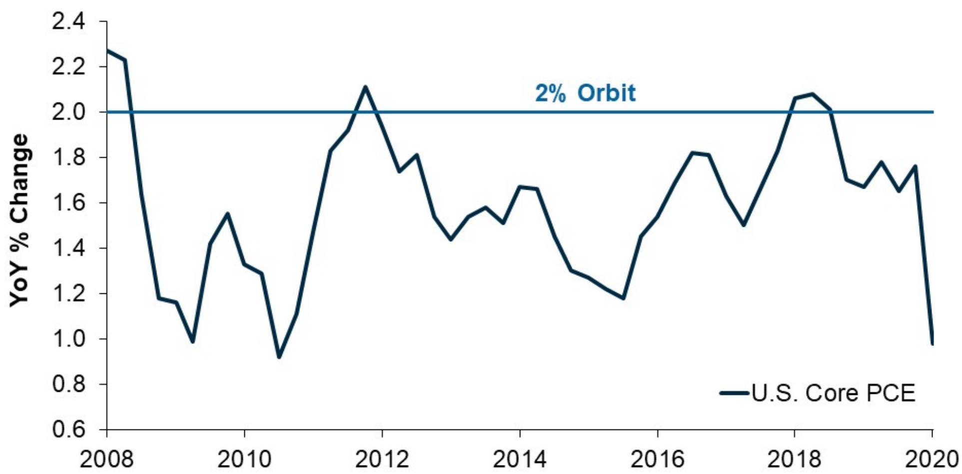
By Erik Schiller, CFA, Head of Liquidity | September 16, 2020

In aeronautics and space flight, one of the most important moments in an spacecraft's launch into orbit is known as achieving "Max Q"—the point at which the increasing velocity of the spacecraft and resulting drag is exactly offset by the decreasing density of the atmosphere. It represents the threshold at which the spacecraft can begin to successfully tilt into orbit. But prior to reaching Max Q, any deviation from the launch trajectory or tilting of the spacecraft usually results in a failure to launch and a trip that is far shorter than planned.

Achieving Max Q is an analogy pertinent to the significant expansionary monetary and fiscal policies of the Federal Reserve and U.S. Treasury as they fight the gravitational forces of deflation in response to the shocks from COVID-19 on the U.S. and global economies. At its recent Jackson Hole symposium, the Fed relayed that its 18-month monetary policy review identified a large gap in realized inflation versus its 2% inflation target (see Figure), which falls under price stability as one of its three mandated goals. The Fed's de facto monetary policy in the post-GFC period was effectively too tight and resulted in the inflation shortfall. Now, the fallout from the COVID-19 pandemic threatens to widen that gap even further.

So, under the Fed's new inflation targeting regime, it will be much less likely to tighten at the first signs of reaching target inflation in the future. But in order to achieve this target (heretofore referred to as "orbit"), we believe that the Fed needs to do more in the current time and space in order to achieve Max Q. While this may not be a prevailing view, the wider the gap grows to the Fed's target and/or the longer it takes to close that chasm, the more questions it raises about the credibility of policy effectiveness.

FIGURE: HOUSTON, WE'VE HAD A PROBLEM[1]



Source: Bloomberg as of June 30, 2020

Deteriorating demographics, increasing debt burdens, and declining money velocity (despite expansionary fiscal and monetary policies) act as the drag forces on the U.S. economy, while traditional QE, credit stimulus, and Fed balance sheet and fiscal expansions act as the thrust. One engine warning light just went off as brinkmanship in Congress has failed to come to a new agreement on the next level of fiscal stimulus. This shifts the burden of incremental thrust

[1] https://www.nasa.gov/feature/50-years-ago-houston-we-ve-had-a-problem

to the Fed. If the Fed acts in its traditional, reactionary ways and waits to implement additional monetary stimulus, it risks failing to reach Max Q, terminal velocity, and orbit at an elevation of 2.0%.

More Thrust, Less Drag

How could the Fed generate more thrust for the economy? Shifting away from “market functioning QE” toward more traditional QE with extended average maturities of their bond purchases would be a good first step at this week’s FOMC meeting. This shift would help remove the incremental duration supply that the Treasury is pushing into the market as it funds current fiscal deficits and should help to reduce long-term interest rates for some additional economic thrust.

Removing, or significantly reducing, the overly restrictive 2.5% long-term median estimate dot from the “dot plot” in the Summary of Economic Projections would provide another boost in altitude. After all, telling the market you expect to be at the zero lower bound on the Fed funds rate for years to come, but then implying that the rate will jump to 2.5%, on average, over the long term communicates tight monetary policy in the years ahead and places more drag on the economy.

In addition, considering negative rate financing for the banking sector, similar to the ECB’s Targeted Longer-Term Refinancing Operations, where they offer very low-rate, term money for banks that can show on-lending into the economy, would also help increase the Fed’s velocity (and correspondingly the velocity of money!).

The U.S. economy is at a critical juncture, and now is not the time to deviate, relax, or let off the thrust. We have not reached Max Q. If there’s any hope of achieving its 2.0% orbit, the Fed should not be letting up now.

This material reflects the views of the author as of September 16, 2020 and is provided for informational or educational purposes only. Source(s) of data (unless otherwise noted): PGIM Fixed Income.

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2020-5810