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INVESTMENT MANAGEMENT

The Policy Puzzle: Procyclical or Countercyclical

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Bottom line: The Fed wants to maintain a less aggressive procyclical policy as it has become more "inflation-aware."

The market is facing a conundrum in terms of how to incorporate the current policy environment into its decision-making process. During the pandemic, policy was clearly procyclical, but recent comments from the Fed suggest policy may be either moving back toward a traditional countercyclical policy, or perhaps a less aggressive procyclical policy. We think the latter.

Let's start with a quick review of some Economics 101 definitions:

- **Procyclical policy** reinforces the current economic cycle. For instance, the Fed wants to keep policy rates easy during strong economic growth, even as fiscal policy is easing (i.e. spending). A procyclical approach marked the pandemic period policy response.
- **Countercyclical policy** counters the current economic cycle. This has been traditional Fed policy since 1980 where they want to be "ahead of the curve" and tighten policy before growth and inflation become too frothy.

The Policy Puzzle

The dilemma for the Fed today is to keep policy easy enough to achieve the following:

1. Extend and reflate the economic cycle in order to close output gap;
2. Facilitate an increase in the labor force participation rate - their "broad and inclusive goal" - **but at the same time;**
3. Keep inflation anchored in the 2 - 2.5% range.

A delicate balance is required, and is easier said than done. If the Fed is too easy for too long and inflation becomes unmoored, then they will need to hike rates sooner in order to keep it from drifting higher - and possibly trigger a recession. If the Fed is not easy enough, or tightens too soon, then the economy will decelerate sharply and they will fall short of their “broad and inclusive” full employments goals. In other words, the Fed may actually kill the economic cycle before the lower demographic of wage earners are able to participate in the economic recovery.

What to expect from the Fed near-term? Discordant voices

We expect a cacophony of differing voices from the Fed in the weeks ahead, all trying to explain this delicate balance the Fed is trying maintain. On June 16 we heard from the more “hawkish’’ Jim Bullard, St. Louis Federal Reserve President, whose “dot” is for a rate hike in late 2022. We are sure to hear from more “dovish” committee members whose dots are in 2023 and even later in 2024.

The key takeaway is that the outcome for Fed policy is not on a pre-set course. It will be dependent on how the economy, growth, inflation and the virus evolve.

How we are thinking about all this

The Fed is still pursuing procyclical policy, but one that is simply less aggressive. Fed policy will still remain VERY EASY throughout 2022 and even into 2023. After all, we are expecting the policy rate to rise only to 0.50% - 0.75% in 2023, despite PCE inflation averaging 2.5% and growth averaging 4.2% over the 2021-2023 period based on Fed projections! This is still PROCYCLYICAL POLICY!!!

As such, the reports of the demise of the global reflation trade are greatly exaggerated. It is still very, very much alive!

Impact: Asset prices from a macro perspective

- **U.S. Treasury (UST) 10-year**: We need to lower the range for 10-year yields from 1.40% - 1.85% to 1.20% - 1.85% for 2021. And we may test 1.20% if the inflation risk premia keeps falling.
- **UST Yield Curve:** Flattening pressures can continue, led by “belly” underperformance (think 5-year sector). However, if the data strengthens and inflation pressures ramp up, then Fed hikes may get more fully priced for 2022.
- **U.S. Dollar:** Falling inflation risk premia will likely lift real rates and this will support the USD. However, we believe the USD remains in a structural bear trend.
- **Emerging Markets (EM):** As some of the reflation fuel is siphoned out of the markets, this may put pressure on EM. But the broad global reflation theme remains intact, and we expect the performance of EM to resume in 2H 2021.
- **Spread Product:** This is a harder call because of current valuations. As government bond yields remain low, there may still be a grab for yield in credit because GDP (i.e. cashflows) will likely remain strong. This supports Spread Product. But if there is a policy mistake that ends the reflation cycle more abruptly than planned, then GDP may suffer and there will be less free cashflow to support spreads at these valuations, with default risks currently too low for this scenario.

For my weekly podcast on this and other macro insights please visit Caron’s Corner on morganstanley.com/im.

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