Bond Blog

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PGIM FIXED INCOME

The Fed and the "Buy-the-Dip" Mentality

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Since the global financial crisis, investors have become accustomed to the “Fed put” during periods of market stress. Severe downdrafts in risky assets and their associated risks to growth were met by a Fed willing to ease policy in an effort to meet the maximum-employment side of its dual mandate. Yet, the existence of that reaction function in the current cycle is a key question for investors contemplating fair value for risk assets. Hence, the following examines the historical evolution of the Fed’s reaction function, estimates the Fed funds target under different inflation environments, and considers scenarios that could prompt the Fed to pivot from its current trajectory. The findings indicate that the Fed put is deeply out of the money and support our cautious outlook for risk assets until inflation starts to observably moderate toward central bank targets.

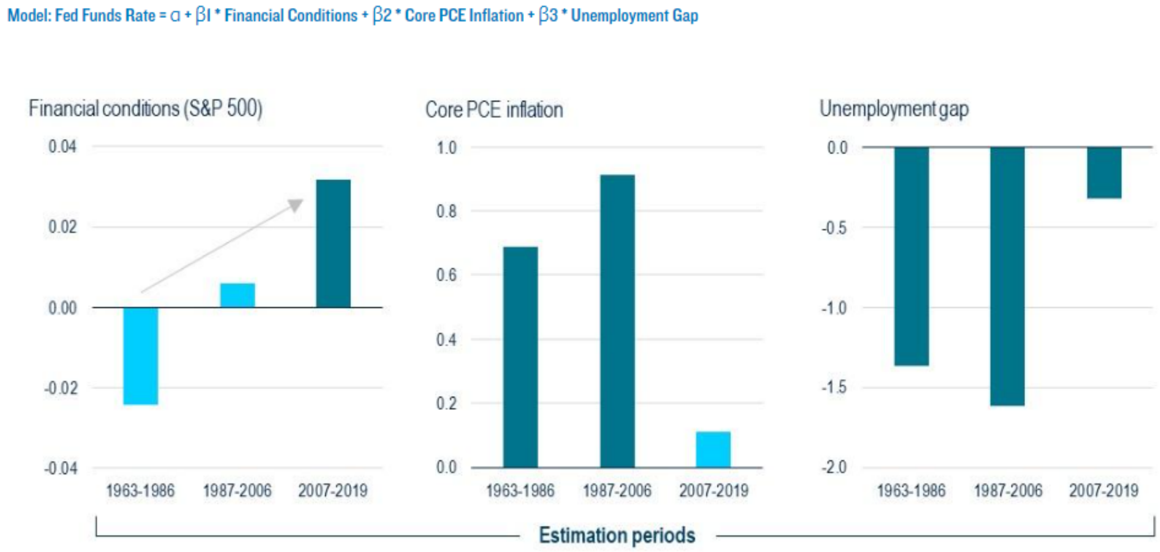
We start with two recent episodes where financial conditions tightened significantly (Figure 1). The first episode emanated from risks to China’s growth in 2015, and the second emerged from a confluence of factors weighing on the outlook in late 2018 - including the Fed’s hawkish stance and the trade war with China. In both instances, the Fed pivoted from its tightening path, providing a crucial backstop to the economy and markets.

FIGURE 1: The Fed Has Become More Sensitive to Financial Conditions Since the Financial Crisis (LHS: Index, lower = tighter; RHS %)

Source: PGIM Fixed Income and Haver Analytics.

However, the Fed has not always demonstrated this degree of sensitivity to financial conditions. To assess the relationship between Fed policy and financial conditions over time, we estimate a Taylor rule augmented with financial conditions and track the evolution of its coefficient.[1,2] After controlling for inflation and unemployment, we observe that the Fed's sensitivity to financial conditions has increased in recent years (Figure 2). Notably, since the financial crisis, tightening financial conditions have been associated with easing Fed policy, whereas the relationship was the opposite from 1963-1986.

FIGURE 2: The Relationship Between Fed Policy and Financial Conditions Has Changed Over Time (β1 Coefficient)



Source: PGIM Fixed Income and Haver Analytics.

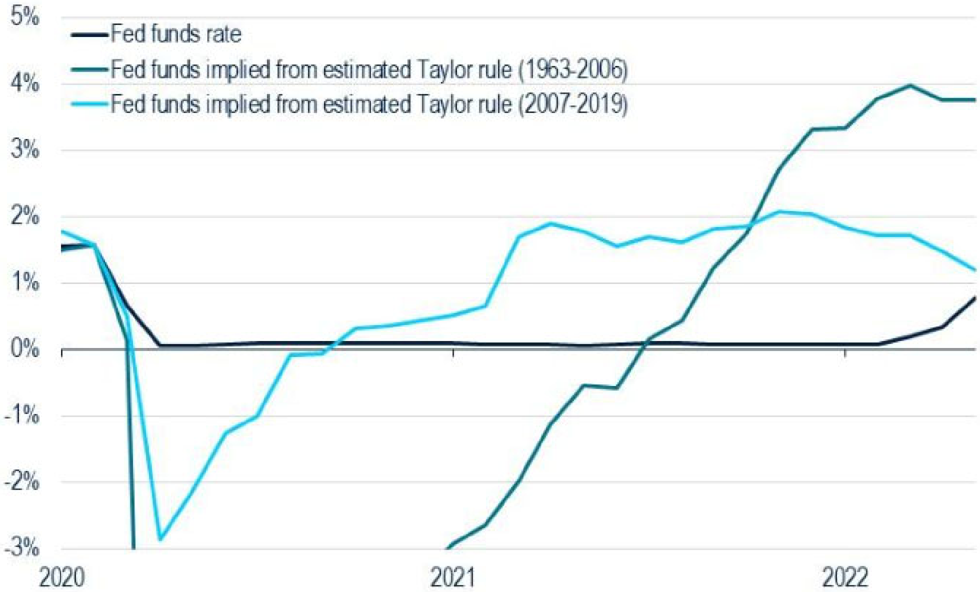
What Changed?

The inflationary environment in each period drove the Fed's changing relationship with financial conditions. In high-inflation environments, the Fed restores the price-stability side of its mandate by tightening policy, which in turn tightens financial conditions (leading to a negative relationship in our prior estimate). Yet, when inflation is low and stable - as in the decade preceding the pandemic - the Fed can focus on maximum employment. Thus, even when the unemployment rate was low, inflation was not a "live constraint," which allowed the Fed to be vigilant in accommodating risks to the outlook and respond to deteriorating financial conditions.[3] This policy backdrop conditioned market participants to "buy-the-dip" after selloffs in risky assets.

However, with inflation now running at multi-decade highs, the markets can no longer count on the Fed put. As the Fed returns to a more conventional conduct of monetary policy to bring inflation back to target, it is actively seeking tighter financial conditions (Figure 1).[4] The upshot is that the Fed is unlikely to bow to financial conditions until "clear and convincing" evidence emerges that inflation is coming back to target.

In Figure 3, we illustrate the difference between a Fed with a "live inflation constraint" and that of the post-GFC Fed using the models from Figure 2. Specifically, we calculate the model-implied Fed funds rate from the augmented Taylor rule using two estimation periods: pre-GFC and post-GFC. The pre-GFC model implies that the Fed would be raising rates to almost 4% - which is roughly in line with their recent projection of 3.8% at the June FOMC meeting. Conversely, the post-GFC model would have the Fed Funds rate at 2% as it would involve easing in response to tightening financial conditions.[5]

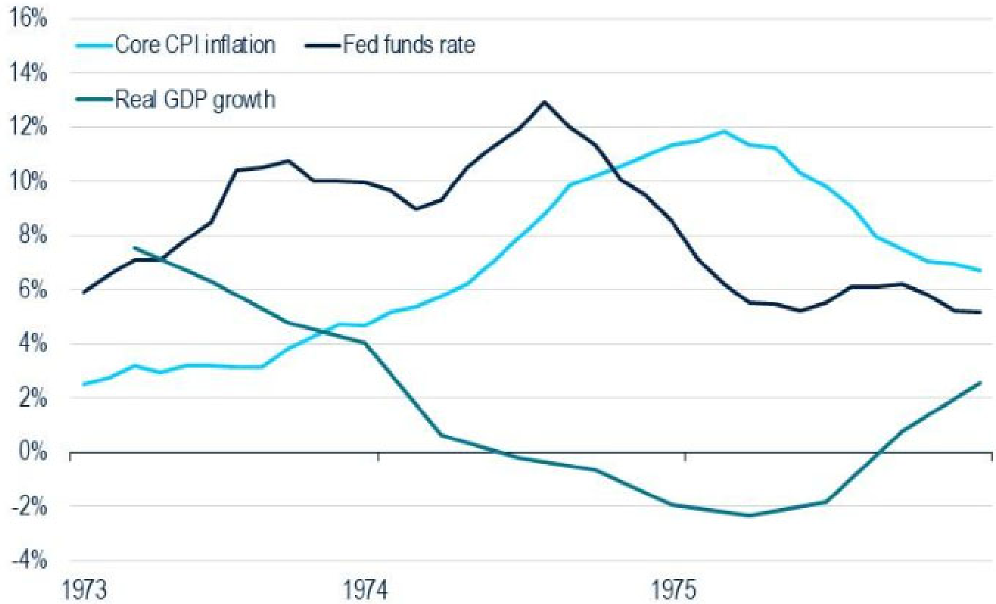
FIGURE 3: The Inflation Backdrop is a Critical Factor in the Fed's Reaction Function (%)



Source: PGIM Fixed Income and Haver Analytics.

Notwithstanding, there is potential for the Fed to reverse course before inflation comes back to 2%. One such scenario might entail a deterioration in economic conditions or demand that clearly indicates subsiding inflationary pressures. We look to the mid-1970s for a historical parallel - the economy tilted into recession and the Fed started cutting well before inflation rolled over (Figure 4). Another possibility is if the Fed were to temporarily accept somewhat higher inflation to prevent the economy from entering recession. This scenario strikes us as somewhat unlikely as it risks a possible unanchoring of inflation expectations and is inconsistent with the Fed's messaging. That said, if inflation was only slightly above its target, it's possible that the Fed would be more comfortable given its flexible average inflation targeting (FAIT) framework, but not when inflation is so high relative to target.

FIGURE 4: The 1970s Show that the Fed Could Pivot Before Inflation Peaks (%)



Source: PGIM Fixed Income and Haver Analytics

All told, a shift in the decade-long inflation backdrop implies that the Fed's reaction function to weakening financial conditions may be far different that it was in the recent past. Furthermore, when fighting inflation, the Fed becomes the source of the shock rather than the shock absorber. Taken together, the evidence suggests the Fed put is deeply out of the money and supports our cautious outlook for risky assets until inflation starts to observably roll over.

Appendix: Regression Results

	Model 1	Model 2	Model 3	Model 4
Core PCE inflation	**0.510**	**0.690**	**0.913**	**-0.212**
(12-month Δ, PP)	(4.5)	(5.8)	(5.0)	(-2.7)
Unemployment gap	**-0.677**	**-1.363**	**-1.613**	**-0.245**
(12-month Δ, PP)	(-5.7)	(-11.1)	(-12.3)	(-5.8)
Financial conditions	**-0.013**	**-0.024**	**0.006**	**0.031**
(S&P 500, 12-month % Δ)	(-2.0)	(-2.2)	(1.2)	(3.9)
Start	Jan. 1963	Jan. 1963	Jan. 1987	Jan. 2007
End	Apr. 2022	Dec. 1986	Dec. 2006	Apr. 2022
Adjusted R-squared	0.299	0.465	0.663	0.485

Source: PGIM Fixed Income.
Note: Regression models include an unreported constant; t-stats in parentheses; Newey-West standard errors used to correct for autocorrelation.

1. The Taylor Rule indicates that three factors—actual inflation relative to target, economic activity relative to full employment, the short-term interest rate needed to be consistent with full employment—should determine the real short-term interest rate.

2. We proxy broader financial conditions using the S&P 500 Index because of data availability. Details of the model estimation can be found in the appendix.

3. We interpret the statistical insignificance of the inflation coefficient during the post-GFC period to reflect the relative lack of inflation-induced policy adjustments compared with other periods. In other words, the exceptional stability of inflation meant it was hardly a constraint on Fed policy.

4. While this policy course pits the Fed's two mandates against each other, Chair Powell made clear in a recent May press conference that the Fed's primary focus was on inflation: "We see restoring price stability as absolutely essential for the country in the coming years. Without price stability, the economy doesn't work for anybody, really. And so it's really essential, particularly for the labor market."

5. After the FOMC's June 2022 meeting, the Fed funds target range stood between 1.50-1.75%, which was on the cusp of the target peak in the cycle prior to the COVID pandemic.

Important Information

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