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Markets and Economy

Hawkish comments by Fed reflect change in tone, not core policy

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Boston - Recently, we have heard a slew of what I would call "mildly hawkish" comments from Federal Reserve Board governors and regional Federal Reserve Bank presidents. This is especially interesting because the observations also came from two who are usually considered dovish. All the comments were generally in the direction of slowing the Fed's tapering sooner rather than later and taking the foot off the accelerator.

Here are a few examples:

"Maybe taking the foot gently off the accelerator would be a wise thing to do here."
— Robert Kaplan, Dallas Fed Bank president (hawk), on May 20

Discussions on slowing bond buying should happen "sooner rather than later."
— Patrick Harker, Philadelphia Fed Bank president (hawk), on May 21

"May well be ... we'll be at the point where we can begin scaling back the pace of asset purchases."
— Richard Clarida, Fed vice chair (dove), on May 25

The Fed is "talking about talking about tapering."
— Mary Daly, San Francisco Fed Bank president (dove), on May 25

> "In general monetary policy parlance, none of the statements could be considered really hawkish. Incrementally, at the margin, they can be viewed as hawkish because they are talking about less easing, but there are also good reasons not to make too much of the comments."

In general monetary policy parlance, none of the statements could be considered really hawkish. But incrementally, at the margin, they can be viewed as hawkish because they are talking about less easing. Indeed, the move by the Fed on June 2 to begin unwinding its corporate bond portfolio — purchased at the start of the pandemic — is a tangible step in this direction.

So the question for investors is whether this represents a fundamental shift in Fed policy. My short answer is no. The new tone is an acknowledgment of the strength of the economy, the recent rise in inflation expectations, elevated asset prices and the substantial fiscal stimulus proposed by the Biden administration.

However, there are also good reasons not to make too much of the comments. The Fed's stated goal is to get inflation over 2%, as measured by core personal consumption expenditures (PCE). In practice, given its recent policy of average inflation targeting (AIT), the Fed can exceed 2% to get the average to 2% over some theoretical period.

To reach that target, the Fed needs monetary policy to be really loose and asset prices to be strong, and by some measures, frothy. My view is that for the most

part, the Fed doesn't care. I think the Fed accepts the trade-off involving elevated asset prices — coupled with some financial stability concerns — to meet its employment and inflation objectives.

This view seems to be reflected in the market, which hasn't registered much of a response. In May, U.S. Treasury yields were roughly flat, even down a few basis points. The dollar has shown modest weakness (the opposite of hawkish policy) and equities have moved higher seemingly every day. To some degree, the market's "ho-hum" reaction is a bit of a surprise, although maybe the market truly believes that the Fed will never let financial stability concerns trump its employment and inflation mandates.

Bottom line: The Fed's recent hawkish comments make sense as a reaction to the significant rebound in economic activity and growing inflationary pressures. But I believe they should be viewed as a fine-tuning, at the margin, of the Fed's core commitment to inflation and employment goals.

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