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Dovish Fed signals commitment to "average inflation targeting"

By: Eric Stein, CFA | March 18, 2021

Boston - The U.S. Federal Reserve reinforced its dovish stance at the March 17 Federal Open Market Committee (FOMC) meeting, while projecting stronger growth and employment, and — importantly — higher inflation. While the Fed said it expects inflation to exceed its 2% target in 2021 and 2023, 11 of 18 FOMC members expect no change to the federal funds rate through the end of 2023. Seven members forecast the rate to exceed its current range of 0% to 0.25% by 2023.

In the Fed's projections, GDP growth for 2021 was bumped up to 6.5% versus 4.2% in December — an increase Fed Chair Jerome Powell attributed to the $1.9 trillion fiscal relief package enacted since the last forecast.

I believe the Fed is sending a clear signal that it takes its recent average inflation targeting (AIT) framework very seriously. The Fed stated: "With inflation running persistently below [the] longer-run goal, the FOMC will aim to achieve inflation moderately above 2% for some time so that inflation averages 2% over time and longer-term inflation expectations remain well anchored at 2%."

In effect, the Fed is asserting its intent to be "behind the curve" on inflation. I don't believe the market fully buys that, so the March 17 statement can be viewed as a step to push the market in that direction. I think we will continue to see a "cat and mouse" game for some time between the Fed and the market, as the central bank tries to explicitly reinforce its commitment to the AIT framework.

The market response to the statement reflected typical volatility around FOMC statements. On the morning after the announcement, the U.S. Treasury curve has steepened — though yields are higher today after falling somewhat yesterday post announcement. The U.S. dollar is still, on net, weaker than it was before the meeting. As for market expectations around the fed funds rate, futures contracts this morning are still pricing in 3.5 hikes by the end of 2023 and 6.2 hikes by the end of 2024.

Bottom line: All in all, the price action indicates that the market still considers this a dovish message from the FOMC. As long as risk assets don't sell off materially and the Fed remains dovish, long-end U.S. Treasury yields could continue to move higher.

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