Could a more dovish Federal Reserve be on the horizon?

Risk to inflation mandate may cause a shift in Fed strategy

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The fallout from the Brexit vote may cause the US Federal Reserve (Fed) to focus greater attention on risks to its inflation mandate. While the Fed seems comfortable with the gradual convergence of inflation toward its 2% target, the Brexit vote increases the risk of falling short. The aftermath of Brexit could dampen inflation through two channels: 1) a resurgence in US dollar strength that curbs inflation pressures through the import channel and 2) increased financial market volatility that leads to tighter financial conditions and reduced lending.

Even before the UK referendum, several indicators had thrown the Fed's inflation target into question. Market-based inflation expectations have been persistently low, and survey-based inflation measures, such as surveys of professional forecasters, have been on a downward trend for several years. Pre-Brexit low inflation expectations exacerbated by post-Brexit disinflationary concerns leave the Fed in a situation where it needs to respond cautiously, in the view of Invesco Fixed Income.

Because the Fed's target interest rate is close to zero, a relapse into disinflation would likely pose very clear risks to the effectiveness of monetary policy. Because the Fed is unable to cut interest rates much without going below zero, it would likely need to engage in further quantitative easing (QE) or other unconventional policy in order to ease. We believe the Fed would rather avoid unconventional policy due to its questionable effectiveness and may first adopt a more dovish message.

We believe a shift to a more dovish Fed (a Fed more apt to cut interest rates) might occur as follows:

1) A prominent Fed speaker (for example, Fed Chair Janet Yellen or New York Fed President William Dudley) might emphasize risks to the Fed's inflation outlook in either a Federal Open Market Committee statement or speech.

2) The Fed might begin to outline the types of policy measures it might consider in the case of a deteriorating outlook. Talking about such policy measures up front might increase market confidence, making it less likely that they would actually have to be used. The Fed would seek to avoid giving the impression that it is out of ammunition.

3) If the economic outlook began to deteriorate significantly, the Fed may make an actual policy shift back to zero interest rates.

4) If further deterioration were to occur, the Fed may resort to unconventional monetary policy – for example, QE or negative interest rates (as a last resort).

Invesco Fixed Income's view

We do not believe that the economy will get to the point where the Fed implements an actual policy shift. Yet, points one and two in the list above seem increasingly likely, in our view. We believe they could occur even if the important economic data fall into a mediocre range (such as weak labor market data of around 150,000 new jobs created per month) and inflation continues to firm only gradually. This would put the Fed in an environment similar to what the

European Central Bank (ECB) experienced in late 2015: growth chugging along fine but its inflation target in danger. If the data strengthen from here (job growth back to around 200,000 per month, for example), then this may all be avoided. However, if payroll growth slows to below 100,000, then we believe the Fed is likely to adopt a dovish stance on an accelerated basis.

The Fed is one of the few major global central banks that has room to lower real interest rates (nominal interest rates less inflation), which are viewed as critical drivers of credit growth and economic activity. Other major central banks either do not have enough inflation to get real interest rates down (e.g., the European Central Bank and the Bank of Japan), or they face the potential to cause a currency crisis if real interest rates are adjusted too quickly (e.g., the People's Bank of China). If global growth disappoints significantly, we believe the Fed is one of the few effective shock absorbers the global economy has left.

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