The Fed's Latest Balance Sheet Guidance: A Compass, Not a Map

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At the December 2020 meeting of the Federal Open Market Committee (FOMC), the Fed kept the pace and composition of its asset purchases unchanged, but provided new forward guidance, in line with expectations. According to the Fed statement, the current pace of asset purchases will remain in place until "substantial further progress" has been made toward achieving the Fed's dual mandate objective. In practice we think this means at a minimum through late 2021.

The Fed has now provided some degree of forward guidance for both of its monetary policy tools – balance sheet and interest rates – completing the transition from crisis management to monetary policy accommodation aimed at supporting the ongoing recovery. While the Fed has spelled out specific metrics it needs to see before it would consider its first policy rate hike since 2018, Wednesday's balance sheet guidance was left vague. This likely reflects significant uncertainty about the economic recovery and a difference in views among members of the committee about the extent to which additional monetary policy support is needed. However, the absence of more specific guidance on the balance sheet also means market participants will be left searching for clues on what "substantial" progress means over the next several quarters, particularly if the recovery is uneven.

The limited reaction in U.S. Treasury markets to the new FOMC statement suggests the Fed has provided enough clarity – for now. But with the Fed forecasting strong growth, a significant drop in unemployment and a slight pickup in inflation (according to the new December 2020 Summary of Economic Projections, or SEP), the Fed at some point will likely need to provide clearer guidance on the reaction function for asset purchases to avoid miscommunication.

'Substantial further progress'

Clear forward guidance is the next step in moving from crisis management, where large asset purchases were used to restore market function, to a monetary policy approach where asset purchases are supporting easy credit conditions. However, the guidance in the Fed statement and in Chair Jerome Powell's press conference did not specify what "substantial further progress" will look like in practice and gave market participants little new information (since the view of ongoing asset purchases was already consensus).

This ambiguity likely reflects two considerations. First, it makes sense to keep guidance vague given the high degree of uncertainty surrounding the economic recovery. The Fed revised its projections significantly in light of the faster-than-expected recovery to date, and the path going forward remains unclear given the unusual nature of this economic crisis. Second, the Fed's messaging also likely reflects a range in views on the committee about the trade-off between the potential benefits and risks of asset purchases. While there is strong agreement within the Fed about the importance of asset purchases in supporting the recovery, several Fed officials have voiced concerns about unintended consequences for financial stability or inequality of doing more than necessary.

Given the Fed's (and our) expectation for a rebound in activity in 2021, more guidance is likely needed eventually; it would help markets understand the line between near-term outcomes and the Fed's longer-term objectives. This is particularly true since the Fed is now tying asset purchases to both its inflation and employment objectives, unlike QE3 (the third round of quantitative easing after the global financial crisis), which focused only on employment. If unemployment and growth were to rebound much faster than expected but inflation remain low, for example, it's unclear if or how the Fed would adjust purchases.

From framework to forecasts

Another interesting takeaway from the December meeting: Despite a meaningful uptick in the Fed's median economic outlook (versus the September 2020 projections), only one additional Fed official is now forecasting an interest rate hike by 2023. We believe this is further evidence of how the Fed's new framework (announced in August 2020 – see our blog coverage, here) is likely to translate into a very patient approach to rate hikes.

Limitations of monetary policy

The ongoing public health crisis is weighing on the U.S. economy and the next several months look likely to be bumpy, which led some market participants to expect the Fed to increase monetary policy support by extending the duration of Treasury purchases at the December meeting. With interest rates low and financial conditions easy, Fed officials did not see a need to add even more support. Instead, the Fed is looking to fiscal policy to help the U.S. economy bridge the gap from the current public health crisis to an improving outlook for 2021. Even though the Fed didn't extend asset purchases and we don't expect them to in our base case outlook, we still see the outlook for the Fed in 2021 asymmetrically tilted toward providing more accommodation if downside risks materialize.

Bottom line

With the U.S. economy currently in a rough patch and a long way from maximum employment and 2% inflation, the Fed used its December meeting to signal that monetary policy accommodation will remain firmly in place. Looking ahead to 2021, we believe the Fed will eventually need to provide more detailed guidance on its reaction function for asset purchases.

Read PIMCO's blog coverage of the Fed's monetary policy framework review, whose results were released in late August 2020: "Monetary Policy Framework: The Fed Says What, But Needs Help on How."

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