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BREAKING NEWS
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No big waves from the Fed to close an unprecedented year

The Federal Reserve sees near-term risks to the outlook due to the worsening coronavirus crisis heading into the winter, even as the outlook for next year has brightened somewhat. Open-market purchases will continue until the economy is substantially back to normal.

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WHAT HAPPENED?

At its last meeting of 2020, the Federal Reserve's Open Market Committee (FOMC) upgraded its economic outlook for the coming years while warning that COVID-19 still represents a significant near-term risk. The most notable change was to tie its asset purchase program more explicitly to its policy mandate. It's clear the Fed intends to keep monetary policy accommodative well beyond the end of the pandemic.

The Fed made few changes to its assessment of the outlook in its statement. It also declined to make adjustments to its bond-buying program, also known as quantitative easing (QE), despite many observers expecting an increase in purchases of longer-dated securities. The Fed did, however, adjust its primary rationale for these purchases from fostering functioning financial conditions to promoting accommodative monetary policy. This subtle change likely indicates that QE will go on well beyond the end of the coronavirus crisis, at least until the U.S. is on track to achieving full employment or inflation seems primed to accelerate beyond 2%.

The Fed's new summary of economic projections raised its GDP growth forecasts for 2020 (to -2.4% from -3.7% in September) and 2021 (to 4.2% from 4.0%). It also sees the unemployment rate falling to 5% by the end of next year and to 4.2% by the end of 2022. Inflation is not expected to average 2% until 2023, which is consistent with 12 of the 17 committee members expecting rates to be on hold at least until 2024.

WHAT IS THE FED'S GOAL?

The Fed has made clear that its goal is not merely to provide emergency relief during the coronavirus crisis, but to also ensure that the U.S. economy returns to its former strength as quickly as possible after the crisis subsides. To that end, its new forward guidance promises the purchases will continue "until substantial further progress has been made toward the Committee's maximum employment and price stability goals." This echoes the Fed's September pledge to not raise its policy rate until inflation seems likely to overshoot the 2% target.

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It seems the bond market has gotten the message. Despite the influx of good vaccine news last month, the 10-year U.S. Treasury yield has risen only modestly to 0.94% from 0.87% as of 31 October. Low interest rates and a relatively flat yield curve have helped foster just about the loosest financial conditions we've ever seen in the United States. Things may get even looser with the breaking news that Congress appears close to a long-overdue fiscal relief deal, which is said to include enhanced aid for unemployed workers, help for small businesses and another round of direct checks to individual households.

A combination of loose fiscal and monetary policies should eventually help the economy run hot, lowering unemployment, supporting labor force participation and raising wages for a broader cross-section of the work force. This represents an important difference in policy approach compared to the one adopted in the prior cycle, when fiscal policy tightened quickly and the Fed raised interest rates in the absence of inflationary pressures. This change holds significance for investors of all stripes.

INVESTING IN A LOW(ER) RATE WORLD

Investors are well aware that interest rates are currently low. But the Fed's promises to continue with its asset purchases until the economy is close to fully recovered should serve as a reminder that they aren't going up anytime soon. Portfolios that are designed to produce income require rethinking and reworking in light of the semi-permanent change to monetary policy in the U.S. and around the world. A core fixed income holding still plays a crucial part in an asset allocation for the diversification it provides. But, increasingly, supplemental sources of income are required from higher-yielding bonds, income-focused equity strategies and alternative investments like private credit, real estate and real assets like farmland.

The 2021 Outlook from Nuveen's Global Investment Committee is titled, "Dark Tunnel. Bright Light.," because we see things evolving in line with the Fed's new forecasts. The world continues to grapple with the coronavirus and its economic effects, even as the first vaccines are administered. The vaccines provide hope for a return to normal life – and normal economic activity – by the second half of next year. In the meantime, however, investors can take steps to ensure they are protected against a worse-than-expected economic and market outcome this winter while still positioned for brighter days ahead.

For more information, please visit us at nuveen.com.

Endnotes

Sources

Federal Reserve Statement, December 2020.

Bloomberg, L.P.

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