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Why we don't expect Fed rate hikes anytime soon

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The U.S. Federal Open Market Committee, the Federal Reserve's policy-setting panel, gets its broad marching orders from Congress. Its dual mandate is to steer the U.S. economy to both price stability and maximum sustainable employment.

The Fed has outlined changes to its monetary policy framework that give us confidence that it won't raise its benchmark federal funds rate target until at least 2023, even as stimulus payments flow through the economy and stock markets remain near record highs.

First and foremost, what is Vanguard's view on recovery from the COVID-19 pandemic?

In the United States, more than two million vaccine doses per day are being administered—a pace that would allow the U.S. to achieve COVID-19 herd immunity at some point this summer.[1]

We expect economic outcomes to start changing, with inflation pressures rising and unemployment falling.

What's the Fed's rationale for patience regarding the labor market?

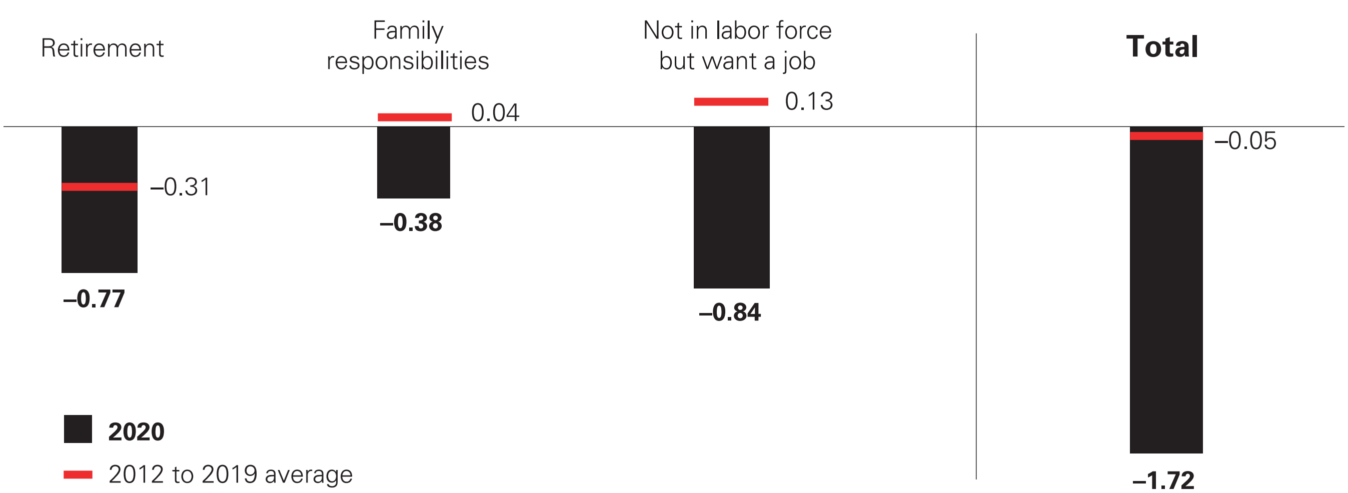
Broadly, the labor market has a long way to go before we can say it has recovered from the pandemic, and perhaps longer before we can say we've achieved full employment.

At this stage of the recovery, especially meaningful are factors such as the labor force participation rate and the stories of people knocked out of the workforce—parents caring for children whose classroom is now the kitchen table or people who lost a job and have given up hope of finding another one. In the context of setting interest-rate targets, the Fed will consider not only broad employment numbers such as the unemployment rate, but also who's out of work and why.

[1] According to the Bloomberg COVID-19 Vaccine Tracker, an average of 2.47 million vaccine doses per day were administered in the United States in the week ended March 17.

How the pandemic has pushed people out of the labor force

Percentage-point change in labor force participation



Notes: The illustration reflects percentage-point changes in the U.S. labor force participation rate attributable to selected reasons for leaving or joining the workforce. Decreases reflect conditions that have kept people out of the labor market. Increases reflect an alleviation of these conditions.

Sources: Vanguard calculations, based on the U.S. Bureau of Labor Statistics' Current Population Surveys.

How does the Fed think about full employment?

When now-U.S. Treasury Secretary Janet Yellen chaired the Fed from 2014 to 2018, she maintained a dashboard that considered, among other measures, job openings, layoffs, underemployment, and long-term joblessness to help determine how much slack remained in the labor market. Current Fed Chair Jerome Powell has made clear he is also seeking improvement in areas that are typically late to recover after a recession, such as labor force participation among workers without college degrees, wage growth for the lowest-paid workers, and Black unemployment. Powell's Fed wants full employment to reflect the full labor market, and rate hikes may not come until it clearly does, or will, reflect that.[2]

What about the Fed's rationale for patience in relation to inflation?

The Fed made an important change to its approach last year to help anchor inflation expectations. It changed its inflation target from specifically 2% to an average of 2% over time. Such a change had been anticipated, as core inflation had been below 2% for so long.

The new average inflation target gives the Fed a buffer to hold rates steady until it's confident that inflation will remain persistently around 2%. We expect an overshoot of 2% core inflation to be short-lived. And we expect the long-term structural trends that have kept inflation low for more than a decade—most notably technology and globalization—to continue to limit price rises, though we'll keep a close eye on the role inflation expectations may play.

How does Vanguard see the $1.9 trillion in new stimulus affecting U.S. growth and inflation?

With the enactment of the stimulus bill, we project that the U.S. economy will register full-year growth in a range of around 7.0% to 7.5%.

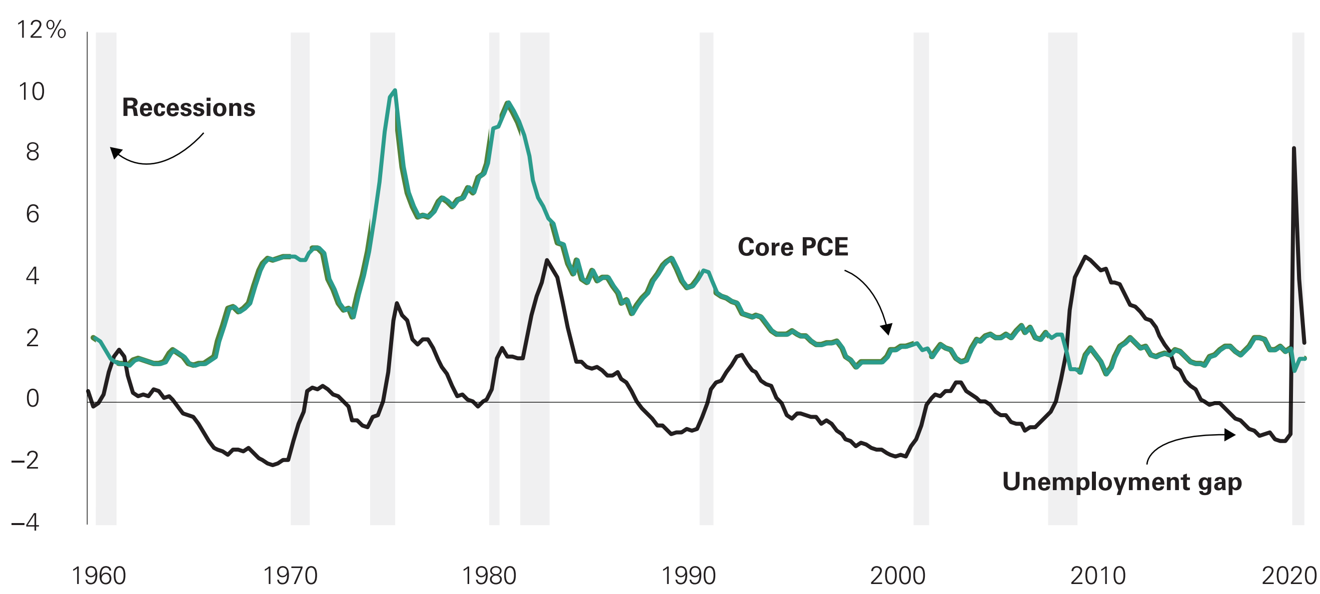
We believe that the stimulus legislation's direct effect on inflation is likely to be modest, around 7 to 10 basis points for all of 2021.[3] Inflation expectations present a risk to our view because heightened expectations can materially affect actual inflation.

This is where the Fed will need to be visible, acknowledging expectations and managing them through careful guidance on its views. For the foreseeable future, we expect its guidance to be that the labor market has a long road to recovery, that inflation expectations remain anchored, and that rate hikes remain relatively distant.

[2] For example, see Fed Chair Jerome Powell's February 10, 2021, speech on the labor market, available at federalreserve.gov/newsevents/speech/powell20210210a.htm.

[3] A basis point is one-hundredth of a percentage point.

Tight labor markets haven't recently triggered worrisome inflation



Notes: The unemployment gap is the headline unemployment rate minus the non-accelerating inflation rate of unemployment (NAIRU). An unemployment gap below zero generally indicates a tight labor market. Core PCE is the U.S. Bureau of Economic Analysis's Personal Consumption Expenditures Price Index excluding volatile food and energy prices—the Federal Reserve's preferred measure of inflation. Recessions are as designated by the National Bureau of Economic Research, the de facto arbiter of U.S. economic recessions. Data through December 31, 2020.

Sources: Vanguard calculations, based on data from the U.S. Bureau of Labor Statistics, the U.S. Bureau of Economic Analysis, the U.S. Congressional Budget Office, and the National Bureau of Economic Research.

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