# WEEKLY UPDATE

## Maximum Employment – the Fed's new objective

In late August every year, the Kansas branch of the Federal Reserve (Fed) organises a symposium in Jackson Hole, Wyoming, on economic and monetary policy. Such meetings often yield little of importance but this year's virtual meeting heralded a sea-change in Fed's policy framework, announced by Chair Jerome Powell. What did he announce, and what does it mean for interest rates and markets?

Powell's speech marked a historic shift in the way the Fed defines its dual objectives of price stability and full employment. Since January 2012, the Fed has defined stability as inflation at 2%, and full employment as being the "equilibrium" level. The two objectives are considered to be linked in economic theory – this relationship, known as the Phillips curve, means that when unemployment falls below its equilibrium level, wage rises begin to push inflation higher and it's time for the Fed to switch to a more restrictive policy.

This theory has been challenged in recent years by persistently low levels of inflation, as measured by the Fed's preferred metric of core personal consumer expenditures (core PCE). Since the 2% target was introduced, core PCE has averaged 1.6% and has only rarely ventured above 2%. In recent years however, the US labour market has been very strong with the headline unemployment rate reaching 3.5% before the coronavirus crisis hit, the lowest since 1968. With the jobless rate well below the equilibrium level at which inflation should have emerged, the Fed appears to have concluded that the Phillips curve was broken.

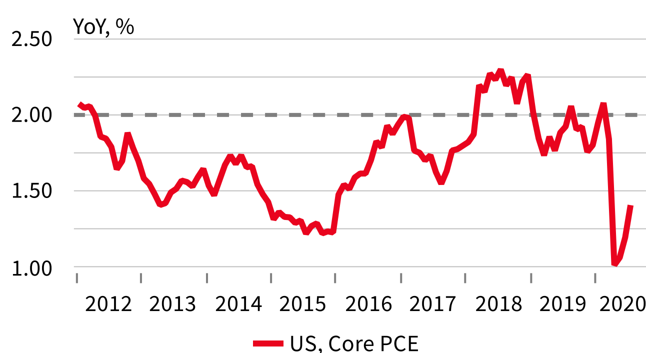
In his speech last week, Powell announced that the central bank is now targeting an average level of 2% over time. This suggests that after an extended period of undershooting its objective, the Fed will be happy to see inflation stay above target to bring the average back in line. But although most reports of Powell's speech focused on inflation, it is arguably the implications for the job market which are the most profound. The Fed has subtly shifted its main focus away from inflation and in favour of employment. Indeed, Powell noted in his speech that the "robust job market was delivering life-changing gains…, particularly at the lower end of the income spectrum" and made maximum employment a "broad-based and inclusive goal". Looking ahead, unemployment can be too high but never too low in the Fed's eyes.

In the near term, all this leaves the outlook for US monetary policy pretty well unchanged. Key rates – the Fed Funds – are already at the zero lower bound, core PCE at 1.3% in July is still well below target while unemployment at 8.4% is far from equilibrium. This leaves the onus on asset purchases to transmit monetary policy and help the Fed achieve its objectives. But the shift in the framework means that the Fed's reaction function will be very different in future – Powell will hope to see unemployment fall well below pre-COVID-19 levels but is unlikely to think about tightening policy until accelerating prices have been well above 2% for an extended period of time.

**Bottom line.** Last week's announcement put some upward pressure on the market's implicit inflation expectations – the difference between yields on fixed-coupon Treasury bonds and inflation-linked securities. However, with the gap between actual and potential levels of activity still extremely wide, we do not expect any lasting rise in prices over the next few years. And with Fed Funds stuck at zero and the Fed set to continue massive asset purchases for the foreseeable future, Treasury yields are likely to remain low, pushing investors towards riskier assets. Finally, any weakening in the economy or failure to bring unemployment much lower would likely trigger renewed Fed easing, further inflaming investors' preference for equities.

**Core PCE has rarely been above 2% since 2012**

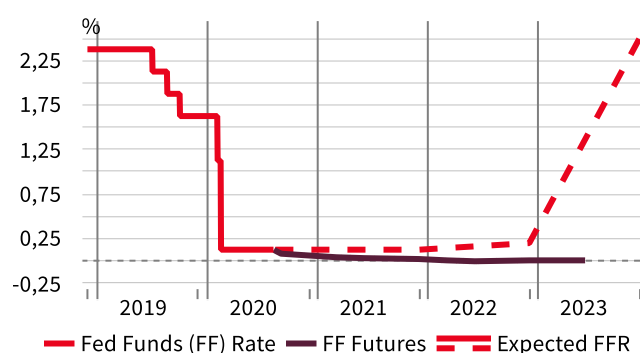
*Core Personal Consumption Expenditures price index (YoY, %)*




*Sources: SGPB, Macrobond,, data as of 04/09/2020*

**Monetary policy should remain very loose**

*Fed Funds Rate and market expectations*




*Sources: SGPB, Macrobond, data as of 04/09/2020*

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# OUR MACRO COMMENTS

## This week and next

EUROZONE

- Final manufacturing PMI eased lower from 51.8 in July to 51.7 in August but remains in expansion territory. At the same time, final services PMI fell from 54.7 to a better-than-expected 50.5.
- Eurozone headline inflation was estimated to be at -0.2% YoY in August, down from 0.4% the previous month. Core inflation fell from 1.2% YoY to 0.4%.
- Retail sales fell for the first time in three months, down -1.3% MoM in July, suggesting that the rebound in consumer spending has run out of steam.

| Next week's key events | | Per. | Prev. | Cons. |
|---|---|---|---|---|
| 07 Sep | Investors confidence | Sep | -13.4 | -- |
| 10 Sep | ECB Deposit rate | Sep | -0.5% | -0.5% |

UNITED KINGDOM

- Final manufacturing PMI rose to 55.2 in August, from 53.3 in July, remaining in expansion territory for the third straight month. Final services PMI increased to 58.8 from 56.5.
- According to Nationwide, house prices rose 2.0% MoM in August, suggesting that the housing market is continuing its post-lockdown recovery.

| Next week's key events | | Per. | Prev. | Cons. |
|---|---|---|---|---|
| 11 Sep | GDP estimate YoY | Jul | -16.8% | -- |
| 11 Sep | Industrial production YoY | Jul | -12.5% | -- |

UNITED STATES

- Final manufacturing PMI came in at 53.1 in August, up from 50.9 in July. At the same time, services PMI rose from 50.0 to 55.0. According to the ISM, manufacturing PMI jumped to 56.0 in August, from 54.2 in July and well above expectations.
- Factory orders rose 6.4% MoM in July, from +6.2% in June, suggesting that the economy is continuing its gradual recovery.
- Construction spending increased 0.1% MoM in July after falling -0.7% the previous month.

| Next week's key events | | Per. | Prev. | Cons. |
|---|---|---|---|---|
| 04 Sep | Unemployment rate | Aug | 10.2 | 9.8% |
| 11 Sep | Inflation rate YoY | Aug | 1.0% | 1.2% |

ASIA & EMERGING

- In China, the official manufacturing PMI stood at 51.0 in August, down from 51.1 in July. The second manufacturing PMI reading published by Markit came in at 53.1 in August from 52.8 in July.
- In Japan, retail sales fell 2.8% YoY in July, from -1.2% in June. Industrial production rose 8.0% MoM in July from +1.9% the previous month. And unemployment hit 2.9% in July from 2.8% in June.

| Next week's key events | | Per. | Prev. | Cons. |
|---|---|---|---|---|
| 08 Sep | Japan: GDP estimate QoQ | Q2 | -7.8% | -- |
| 09 Sep | China: inflation rate YoY | Aug | 2.7% | 2.4% |

Sources: DataStream, Bloomberg, 04 September 2020. Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, PMI = Purchasing Manager's Index.

## Our 3-month targets for currencies and commodities

| | Thursday close | 3mth target |
|---|---|---|
| EUR/USD | 1.19 | 1.19 |
| GBP/USD | 1.33 | 1.31 |
| EUR/CHF | 1.08 | 1.09 |
| USD/JPY | 106.2 | 107.0 |
| Brent | $44.1 | $43.5 |
| Gold (oz.) | $1935 | $1900 |

NB our latest changes to 3-month targets.

Forecast figures are not a reliable indicator of future performance.

# MARKET PERFORMANCE

| Interest rates | Last | 1wk | | 3mth | YTD | 12mth |
|---|---|---|---|---|---|---|
| EONIA (EUR) | -0,47 % | 0 bp | → | -1 bp | -2 bp | -11 bp |
| 3mth Euribor (EUR) | -0,48 % | 0 bp | → | -14 bp | -10 bp | -3 bp |
| 3mth Libor (USD) | 0,25 % | 0 bp | → | -8 bp | -166 bp | -188 bp |
| 3mth Libor (GBP) | 0,07 % | 1 bp | → | -16 bp | -72 bp | -68 bp |
| 10-year US Treasury bond | 0,62 % | -12 bp | ↓ | -14 bp | -129 bp | -84 bp |
| 10-year German bond | -0,49 % | -9 bp | ↓ | -14 bp | -30 bp | 23 bp |
| 10-year French bond | -0,19 % | -8 bp | ↓ | -21 bp | -32 bp | 21 bp |
| 10-year UK bond | 0,24 % | -10 bp | ↓ | -4 bp | -59 bp | -17 bp |

| Credit | 1wk | | 3mth | YTD | 12mth |
|---|---|---|---|---|---|
| BAML EURO Corp. IG | 0,5% | ↑ | 3,2 % | 0,9 % | -0,3 % |
| BAML EURO Corp HY | 0,5% | ↑ | 4,2 % | -1,5 % | 0,3 % |
| BAML GBP Corp IG | 1,3% | ↑ | 3,8 % | 5,5 % | 4,6 % |
| BAML US IG | 1,4% | ↑ | 4,8 % | 7,9 % | 8,2 % |
| BAML US HY | 0,3% | ↑ | 4,8 % | 0,9 % | 4,0 % |
| BAML Global EM Sov. External Plus | 1,4% | ↑ | 7,6 % | 1,8 % | 4,3 % |

| Exchange rates | Last | 1wk | | 3mth | YTD | 12mth |
|---|---|---|---|---|---|---|
| EUR/USD | 1,19 | 0,2 % | ↑ | 5,5 % | 5,7 % | 8,0% |
| EUR/CHF | 1,08 | 0,3 % | ↑ | -0,2 % | -0,7 % | -0,5% |
| GBP/USD | 1,33 | 0,6 % | ↑ | 5,6 % | 0,2 % | 9,9% |
| USD/JPY | 106,2 | -0,4 % | ↓ | -2,5 % | -2,2 % | 0,2% |
| USD/BRL | 5,29 | -5,0 % | ↓ | 4,5 % | 31,7 % | 27,0% |
| USD/CNY | 6,85 | -0,7 % | ↓ | -3,8 % | -1,7 % | -4,6% |
| USD/RUB | 75,3 | 0,4 % | ↑ | 9,8 % | 21,6 % | 12,8% |

| Government bonds* | 1wk | | 3mth | YTD | 12mth |
|---|---|---|---|---|---|
| United States (3-7yr) | 0,4 % | ↑ | 0,8 % | 7,3 % | 6,3 % |
| United Kingdom (3-7yr) | 0,5 % | ↑ | 0,5 % | 3,1 % | 1,6 % |
| Germany (3-7yr) | 0,4 % | ↑ | 0,5 % | 0,7 % | -1,6 % |
| Japan (3-7yr) | 0,0 % | → | -0,1 % | -0,2 % | -1,3 % |

| Equities* | Last | 1wk | | 3mth | YTD | 12mth |
|---|---|---|---|---|---|---|
| MSCI AC World | 579 | -0,6 % | ↓ | 10,1 % | 4,1 % | 16,7 % |
| Eurostoxx 50 | 3 304 | -0,7 % | ↓ | 1,9 % | -9,6 % | -0,7 % |
| DAX | 13 058 | -0,3 % | ↓ | 4,6 % | -1,4 % | 9,6 % |
| CAC 40 | 5 010 | -0,1 % | ↓ | 0,5 % | -14,6 % | -6,3 % |
| S&P 500 | 3 455 | -0,8 % | ↓ | 11,1 % | 8,4 % | 21,2 % |
| FTSE 100 | 5 851 | -2,4 % | ↓ | -7,4 % | -20,4 % | -16,6 % |
| SMI | 10 221 | -0,2 % | ↓ | 0,4 % | -0,6 % | 7,3 % |
| Topix | 1 631 | 1,0 % | ↑ | 2,2 % | -3,9 % | 10,7 % |
| IBOV Brazil | 100 721 | 0,1 % | → | 8,3 % | -12,9 % | 1,0 % |
| MICEX Russia * | 2 932 | -2,7 % | ↓ | 3,6 % | -3,7 % | 5,7 % |
| MSCI EM | 1 109 | -0,7 % | ↓ | 13,4 % | 1,4 % | 17,0 % |
| SENSEX 30 India | 38 991 | -0,3 % | ↓ | 15,0 % | -4,5 % | 7,8 % |
| Hang Seng (H-K) | 25 008 | -0,9 % | ↓ | 4,7 % | -8,8 % | 1,4 % |
| Shanghaï Composite | 3 385 | 1,0 % | ↑ | 15,8 % | 11,0 % | 15,5 % |

| Commodities | Last | 1wk | | 3mth | YTD | 12mth |
|---|---|---|---|---|---|---|
| Brent | $44,1 | -2,3 % | ↓ | 10,6 % | -33,5 % | -23,6 % |
| Gold | $1 935 | 0,9 % | ↑ | 14,1 % | 27,3 % | 24,9 % |
| Copper | $6 575 | -1,0 % | ↓ | 19,6 % | 6,9 % | 17,7 % |

Source: DataStream, on 04 September 2020.

1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7-year returns. Figures are rounded.

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