HMV WEALTH ADVISORS

Monthly Client Letter
October 2020

We have become used to planning around low interest rates, both this year and during the last decade. And we might not see rates increase for the foreseeable future after Federal Reserve Chairman Jerome Powell announced a significant policy change in August. Let's take a look at what the Fed's shift to an "average inflation" target means for future inflation expectations, fixed income markets, and your portfolio.

This policy change, the product of a year-long internal policy review, is seismic in scope and will greatly affect how the central bank manages inflation moving forward. Prior to this shift, the Fed historically had relied on inflation models and adjusted monetary policy based on these forecasts to achieve their 2% inflation target. This strategy effectively ignored prior inflation rates when setting future policy. The new Fed policy means those prior inflation rates are now an important part of future monetary policy. Moving forward, the Fed will target an average inflation rate of 2% over time, letting inflation exceed the target for potentially long periods to make up for periods when inflation fell short of the 2% target. The Fed noted that the reason behind the policy change was recent evidence showing that the relationship between the unemployment rate and inflation has shifted.

Specifically, unlike previous decades, the last 10 to 15 years have demonstrated that lower levels of unemployment have not led to higher inflation.

The shift to average inflation targeting is broader and more subjective than prior Fed policy. With this shift, market participants need to evolve their thinking on the fixed income markets, as it is much less clear how the Fed will react in response to new economic data. Based on this new approach, it is likely we will see the following circumstances occur.

First, we will likely see federal funds rates remain lower for longer and accompanied by steeper Treasury yield curves. When the economy begins to recover from the COVID-19-induced recession, the Fed is now much less likely to raise interest rates right away. Most likely, the Fed will let inflation run above its 2% target for an extended period of time. Also, as the economy improves (assuming that the Fed does not raise rates), it is highly likely we will see a steeper yield curve, as investors may demand a larger premium for holding long-term bonds due to the new uncertainty around potential Fed action.

Second, future inflation expectations have become more uncertain. With the Fed's shift to a significantly more subjective policy, there will of course be more uncertainty about future inflation. This uncertainty will most likely lead investors to demand a greater inflation premium to hold traditional nominal bonds.

Importantly, your portfolio accounts for these changes by holding a ladder of short-to-intermediate nominal and, in some cases, inflation-protected bonds. Laddered portfolios protect investors in both falling and, in this scenario, rising interest rate environments by balancing term risk and reinvestment risk. Longer-term bonds typically have higher yields than shorter-term bonds but contain more term risk, as changes in interest rates have a greater impact on their market value. Buying shorter-term bonds can lower term risk, but it also exposes your portfolio to reinvestment risk and lower yield. Reinvestment risk is the risk that your portfolio could be forced to reinvest bond proceeds at a lower rate than the previous investment.

By utilizing a ladder, whether that occurs inside or independent of a bond mutual fund, intermediate-term bonds hedge against reinvestment risk and provide higher yields while short-term bonds hedge against term risk. This balanced approach protects your fixed income portfolio from large swings in value in both rising and falling interest rate environments, making it a valuable, versatile tool for helping you reach your most important financial life goals – however events from the Fed's recent policy change play out.

When you have any questions about your investments, need to inform us of family or work-related changes, or want to discuss your financial planning needs, please reach out. We are ready to help.

Sincerely,

HMV Wealth Advisors, LLC

Message to clients: Please contact us if there have been any changes in your financial situation or investment objectives (or investment restrictions that you may wish to impose) that may affect our management of your accounts.