What Happens When the Fed Stops Showing Its Hand?

Less guidance from the Fed may give policymakers more room to maneuver—but it could also increase uncertainty for investors.

What You Should Know

- Federal Reserve (Fed) Chair Kevin Warsh's move away from forward guidance represents a significant shift in how the Fed communicates with financial markets.
- Supporters believe less guidance could give policymakers greater flexibility and encourage investors to focus more closely on economic fundamentals.
- Critics warn that reduced transparency could increase interest-rate volatility, potentially raising borrowing, funding, and hedging costs throughout the financial system.
- A less predictable policy environment may expand opportunities for active managers to adjust portfolio positioning.
- Diversification[1] across fixed-income sectors and maturities may help investors manage uncertainty and pursue opportunities as market conditions evolve.

Insight From Hartford Funds

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When Kevin Warsh, the newly appointed Fed chair, met with reporters for the first time last June following his inaugural Federal Open Market Committee (FOMC) meeting, his message was clear: Forward guidance on future Fed decisions would likely be a thing of the past.

To drive home his point, Warsh even abstained from providing a dot-plot projection on his own expectations of the future federal-funds rate. This was a significant departure from recent predecessors who, in the aftermath of the Global Financial Crisis (GFC), began using press conferences in 2011 and the dot plot in 2012 to help guide the markets.

Why Is the Fed Moving Away From Forward Guidance?

Warsh believes markets should be shaped by data—not the Fed. In his view, forward guidance gives the Fed too much market influence and can constrain policymakers when conditions change.

Consider what occurred in 2018, when the Fed had been steadily raising rates and signaling the likelihood of additional rate hikes to come. In the last four months of the year, the S&P 500 Index[2] dropped 17.09%, peak to trough, and high-yield credit spreads[3] widened over 200 basis points (bps)[4] in the fourth quarter (**FIGURE 1**).

[1] Diversification does not ensure a profit or protect against a loss in a declining market.

[2] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

[3] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

[4] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

FIGURE 1
A Shift in Powell's Tone Changed Market Sentiment Long Before Rates
S&P 500 Price Index and High-Yield Credit Spreads Before and After the Powell Pivot

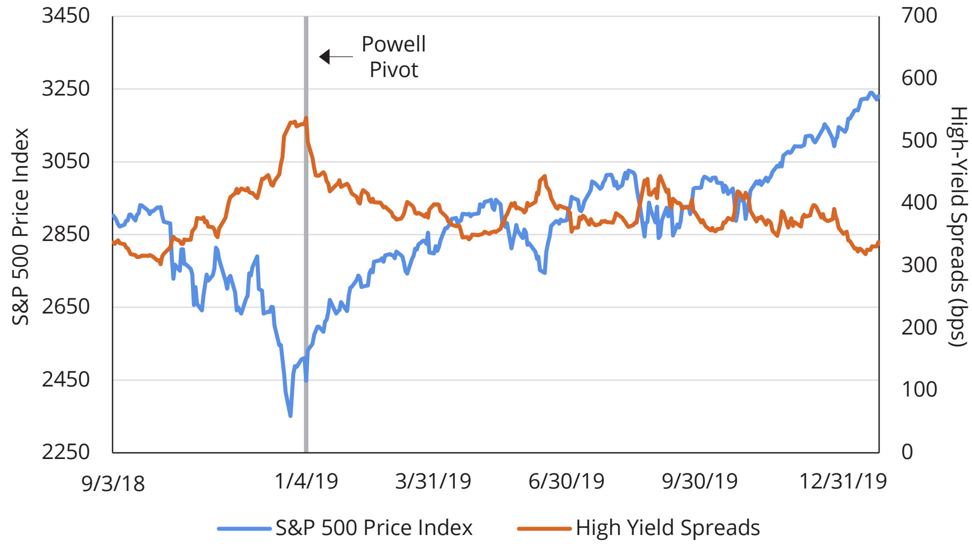

Chart Data: 9/3/18-12/31/19. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. The S&P 500 Price Index is a market capitalization-weighted price index composed of 500 widely held common stocks, and does not include the reinvestment of dividend payments. For illustrative purposes only. Sources: NDR, FactSet, and Bloomberg, 9/26.

> Markets were responding to Powell's words before they were responding to Powell's actions.

But while markets were calling for a pause, the Fed chair at the time, Jerome Powell, consistently communicated that the economy was strong, with low unemployment and little or no inflation. The Fed moved ahead with its planned hikes in September and December, but it wasn't until January 2019 that Powell shifted his language, emphasizing that the Fed would be "patient" with future hikes.

The "Powell Pivot" saw equities rally 13.65% and high-yield spreads contract over 130 bps in the first quarter. It put a spotlight on how much influence Fed communications can have in moving markets. The Fed didn't actually cut rates until July 31, 2019, but the impact was already felt.

Warsh hopes that by curtailing forward guidance, markets will rely on real-time market fundamentals instead of taking its cues from the Fed. In his words, he wants the market to "play the ball and not the referee." In addition, he believes the lack of guidance gives the Fed more freedom to change course as the facts warrant without being locked into guidance it may have provided weeks before.

Warsh has formed a task force to review the Fed's communications framework, including the future of the dot plot, how press conferences are conducted, and how FOMC statements are released. All in all, this represents a drastic shift from the past 15 years of Fed communications.

The Risks of a Less Transparent Fed

While every new leader has the right to reexamine how key functions are carried out across their organization, changes in Fed communications, or even uncertainty surrounding them, carry risks.

A less communicative Fed would not be unprecedented. During Alan Greenspan's tenure as Fed chair from 1987–2006, policymakers revealed far less about their intentions in the early years, leaving investors to hunt for clues. Market watchers even scrutinized Greenspan's briefcase: A bulging case supposedly signaled a rate hike, while a slimmer one suggested no change. The colorful but unreliable theory illustrated how little official guidance markets sometimes had. Transparency increased during Greenspan's later years, but greater openness ensued under Ben Bernanke's leadership as the Fed accelerated its use of communications to clarify its thinking and reduce uncertainty following the GFC.

But reversing that trend could make policy more difficult to anticipate, prompting investors to price in a wider range of outcomes and demand greater compensation for uncertainty. The result could be more interest-rate volatility and, potentially, structurally higher rates. Think about banks that fund themselves in multiple ways (deposits, bonds, equity) over various terms (short, medium, long). If even a portion of their fund pricing becomes harder to predict, the bank will need to account for potential higher costs, which can be passed on to borrowers for mortgages, auto loans, and other forms of credit.

Further, greater rate volatility generally makes hedging more expensive, more difficult, and less precise, which can have significant consequences across the financial system. This volatility drives up costs, not just for banks and mortgage lenders but also for insurance companies, pension funds, and fund managers. The potential exists for higher costs or lower margins across a number of industries.

> "As policy becomes less predictable, interest rates may experience larger and more frequent swings.

How Investors Can Navigate a Less Predictable Fed

Less forward guidance doesn't necessarily mean markets are headed for a wild ride or that interest rates will soar. Still, the effects of greater rate volatility will likely be felt first and most directly in fixed-income markets. Those effects won't necessarily be negative for every investor. As policy becomes less predictable, interest rates may experience larger and more frequent swings, potentially making it more difficult for passive strategies to outperform as market conditions change.

Active managers, however, may be better-positioned to navigate this environment by dynamically adjusting portfolio duration[5] and yield-curve[6] exposure as economic conditions evolve. Regardless of the approach, diversification will remain important. Maintaining fixed-income exposure across multiple sectors and a range of maturities can help investors manage risk, strengthen portfolio resilience, and pursue opportunities that may arise in different segments of the bond market.

The Verdict Is Still Out

Fed Chair Warsh is attempting to significantly alter the way in which the Fed communicates. Supporters argue that less is more, and that the revised approach will improve policy flexibility, reduce the market's reliance on Fed forecasts, and encourage investors to focus on economic fundamentals rather than attempting to interpret every nuance of Fed messaging. Critics, however, contend that removing a key source of transparency could increase uncertainty, contributing to greater interest-rate volatility and higher costs throughout the financial system.

Time will tell if the advantages of greater policy flexibility outweigh the costs of reduced predictability. In the meantime, investors should be prepared for a world in which economic data, rather than Fed forecasts, will play a larger role in driving market outcomes.

[5] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[6] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

To learn more about today's opportunities in fixed income, talk to your financial professional.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed income security risks include credit, liquidity, call, duration, and interestrate risk. As interest rates rise, bond prices generally fall. • Investments in high-yield ("junk") bonds are considered speculative, involve heightened credit risk and greater risk of price volatility, illiquidity, and default than investment grade bonds.

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