With the top two positions at the Federal Reserve soon to be open, Russ discusses how the easy money era goes back a long way.

Last week, Stanley Fisher, Vice-Chair of the Federal Reserve (the Fed), unexpectedly announced that he will be stepping down. This means uncertainty as to who will fill both the #1 and #2 leadership positons at the Fed, not to mention several other vacancies on the Board of Governors.

However, while a change in leadership can certainly impact monetary policy, it is worth recalling that dovish monetary policy precedes the current leadership. In fact, a tradition of easy money goes back nearly 20 years, a trend that has shaped most investor portfolios.

Just how big an impact this dovish monetary policy has had can be seen by real—i.e., inflation-adjusted—interest rates. While there is no single, correct measure of monetary policy, this is a good proxy. Over the very long term the real federal funds rate (RFFR)—defined as the effective fed funds rate minus the one-year change in the Consumer Price Index—has averaged around 1.25%. However, that average masks significant variation.

Back in the late 1970s, the RFFR was consistently negative as central bankers struggled to adjust to an unexpected surge in prices. That dynamic changed under Fed Chair Paul Volcker. The Volcker Fed aggressively raised rates, taming inflation in the process. However, real rates remained stubbornly high for years as everyone awaited the eventual return of inflation. As we now know, it never came.

Instead, what changed was the U.S. trend growth rate, a shift that occurred around the time of the tech-bubble collapse. As both real and nominal growth slowed, monetary policy took on a very different hue. With the exception of a short-lived tightening cycle in 2005–2006, the RFFR has tended to be negative since 2001. See chart below.
This trend toward low or negative real rates has only accelerated in the post-crisis period. Since 2009 the average RFFR has been below -1%. And unlike the 1970s, today negative rates are occurring in the context of historically low inflation. In other words, negative rates are not a byproduct of a Fed caught off guard; they are a deliberate policy choice.

This is important for many reasons. One of the more obscure but important ones is that the monetary environment tends to affect the co-movement of assets. As I discussed in my July blog, The geekiest (and most important) number nobody is discussing, stock/bond correlations have tended to correlate with Fed policy. Historically, the level of RFFR has explained 30% of the variation in stock/bond correlations. A less formal way of saying this: When people are not afraid of the Fed, they buy bonds for safety.

Whichever path a newly constituted Fed takes, it will matter for many reasons, including whether bonds continue to provide a reliable hedge against equity risk. While claiming no special knowledge of the next Fed Chair and Vice-Chair, I have to note that easy money and the Fed now go back together a very long way.

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