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## Credit Markets: A New Policy Paradigm

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***The Federal Reserve announced a significant change in policy during Q3 2020.***

The biggest news during the third quarter for credit markets came in late August with Fed Chairman Jerome Powell announcing a change in Fed policy. Going forward, the Fed will focus on "symmetrical inflation targeting," a fancy way of saying the Fed will allow inflation to run above its 2% target in an effort to generate "average" inflation of 2% over time.

Since the Great Financial Crisis in 2008-2009, inflation has remained stubbornly below the Fed's 2% target. This new framework will allow for inflation (assuming greater inflation does eventually materialize) to run faster than 2% for some time before tighter monetary policy measures are deployed. This policy is also dependent on the Fed's second mandate: to achieve "full employment."

As of this writing, the Federal Reserve Bank of St. Louis 5-Year Breakeven Inflation Rate (T5YIE) currently sits at 1.52%*, meaning market participants are expecting around 1.52% annual inflation over the next 5 years. If these expectations are correct, this could mean the Fed won't tighten monetary policy for many years to come – not welcome news for income-oriented investors.

Another potential result of this change in the Fed's policy framework is that it may, over time, make equity valuations less risky relative to bonds. If equity investors begin to see inflation tick up, but know the Fed is unlikely to act due to this policy shift, equities have a lower probability of reacting negatively as inflation is rising. This would also mean equities could generally command higher absolute valuations than has historically been the case. It remains to be seen, but this new paradigm may have far -reaching consequences for investors.

For the quarter, all major categories of bond issues appreciated on a total return basis. The benchmark 10-year U.S. Treasury yield ticked up slightly from 0.66% at the beginning of the quarter to finish at 0.69%. Mortgage rates continued to fall during the quarter, with 15-year fixed rate mortgages hitting a new record low of 2.49% and 30-year fixed rate conforming mortgages at a new low of 3.05%**.

*FRED, October 13, 2020

**Bankrate.com, September 30, 2020

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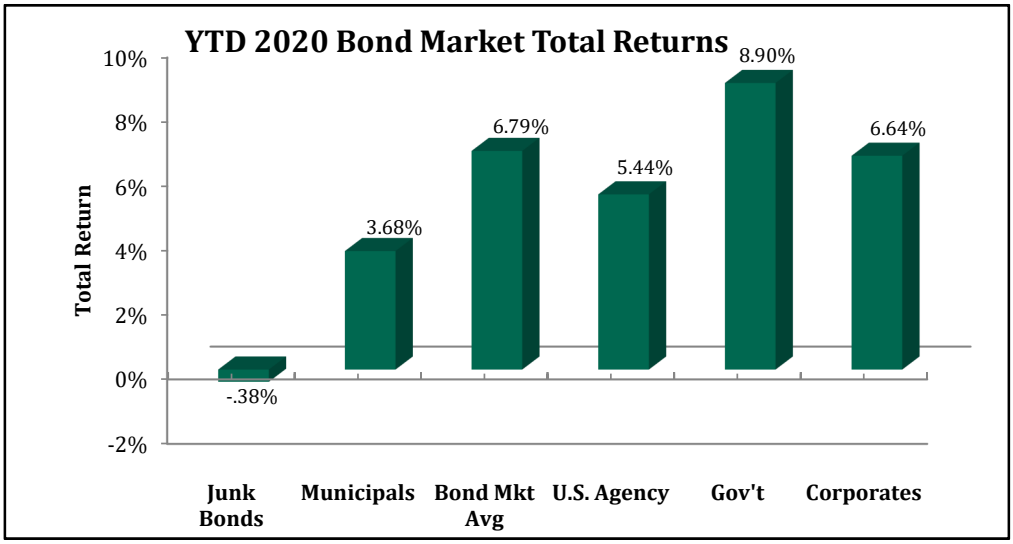


Source: Wall Street Journal

**Bond Market Yields 9/30/2020**

| | | | |
|---|---|---|---|
| Average Money Market Fund | 0.22% | 10 Yr. AAA Muni Bond | 0.84% |
| 5 Yr. AAA Muni Bond | 0.29% | 10 Yr. AA Corporate Bond—Long Term | 1.51% |
| 5 Yr. AA Corporate Bond—Intermediate | 0.70% | 10 Yr. U.S. Treasury | 0.69% |
| | | 30 Yr. Fixed Rate Mortgage (Conforming) | 3.08% |

Source: Bankrate.com