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Demand-Side Inflation to Determine Peak Policy; Supply-Side Issues Transcend Monetary Policy in Timeline for Rate Cuts

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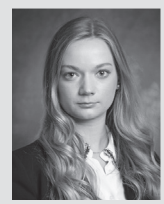

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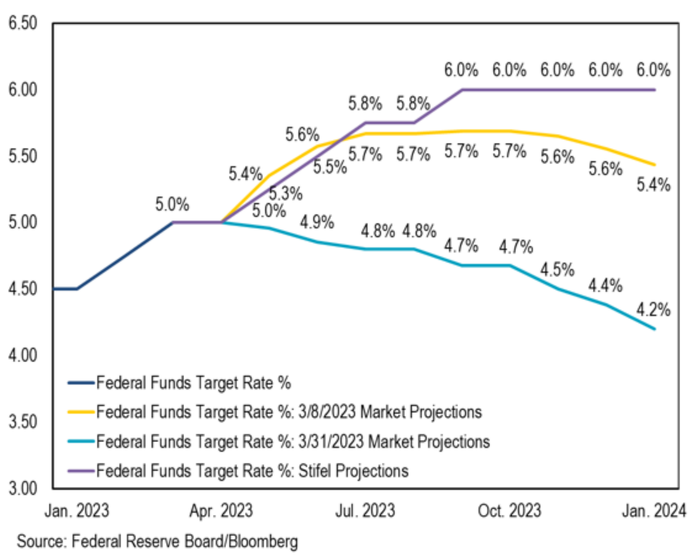
With the March Federal Open Market Committee (FOMC) meeting in the rear-view mirror, investors have turned their attention to the next Federal Reserve (Fed) policy directive less than five weeks away. While the Fed has not taken its eye off the proverbial ball of price stability, the composition of the actions needed to achieve it appears to be evolving with the expectation of tighter credit conditions in light of the recent banking crisis.

Of course, while a more organic adjustment in credit conditions may remove some pressure on the Fed to raise rates as high as previously expected, the Committee won't necessarily accelerate a timeline for rate cuts as there is no guarantee that inflation will sufficiently subside. If price pressures remain elevated, the Fed may be forced to keep rates at or near the terminal level for a prolonged period of time. Possibly complicating the equation for price stability is the impact of lingering supply-side issues despite market expectations for a reduction in policy as soon as July.

TIGHTER CREDIT, LOWER RATES

With inflation still *"well above"* the Fed's preferred 2% target, it is clear the Committee has more work to do beyond the latest 25 basis point rate hike last month. The burden on the Fed, however, to tame inflationary pressures could be mitigated somewhat by the tighter lending conditions stemming from recent distress in the banking industry. If realized, higher lending standards would aid the Fed's efforts to slow growth and reduce inflation by tamping down investment and consumption. This essentially could reduce the peak level of rates needed to rein in inflation. It also would help alleviate some of the pressure financial institutions have felt during the precipitous climb of the fed funds rate over the past 12 months.



Source: Federal Reserve Board/Bloomberg

As we have long predicted, a policy firming level nearer 6% will likely be necessary to ensure a return of price stability. However, if tighter credit conditions can accomplish what 50 or 75 basis points of tightening would do to inflation, then the peak level of rates may not need to rise quite as high as 6%. In this case, perhaps a peak of only 5.5% or maybe 5.25%, meaning one more rate hike may prove adequate with the total *"firming"* of policy being a combination of additional rate hike(s) *and* a more organic adjustment in credit conditions.

Of course, the effects of recent market volatility remain far from certain. As Federal Reserve Chairman Jerome Powell was very clear, *"it's highly uncertain how long the situation will be sustained or how significant any of those affects would be."* Thus, if recent market events have a minimal or modest impact on conditions and by extension inflation, then the pathway for rates will likely be more aggressive, meaning a higher terminal rate nearer expectations pre-Silicon Valley Bank. On the other hand, if recent action results in significantly tighter credit conditions that would mean monetary policy has less work to do. .

PEAK VERSUS CUT

The shift in the Fed's recent policy statement emphasizing the totality of *"policy firming"* versus rate hikes alone has redirected the market's focus to the eventual peak in fed funds. The conversation, however, has fallen short in identifying the longer-run pathway for rates. The market presumes that the question has always been how high? And once that is determined, a reduction in rates will quickly follow suit. Such an assumption, however, appears to be lacking a global assessment of conditions and an understanding of the dual-sided equation that created the highest levels of inflation in the U.S. since the 1980s. After all, even if the terminal level of rates is lower than previously thought, should inflation remain elevated as a result of ongoing global supply-side issues, the Fed is not likely to reengage in additional rate increases, but it also is unlikely to cut rates.

The Fed was arguably late to the inflation-taming party with a longstanding view of inflationary pressures being *"transitory."* Now, in an effort to make up for lost ground, the Fed has increased rates 475 basis points in 12 months, the fastest pace of ascension in more than four decades. As the Fed presumably continues to tighten policy, coupled with an expectation of tighter credit conditions, economic growth will presumably be slowed into a downturn, if not choked off entirely into recession. While seemingly undesirable for households and businesses, from a macro policy perspective, such a reduction in activity will seemingly have the desired impact on slowing price pressures – at least somewhat – by undermining the *demand* side of the inflation equation.

Source: Bloomberg

The supply side of the price equation, meanwhile, still remains an unknown variable. It poses upside risks to the inflation outlook over which the Fed has no control. The

GLOSSARY

FOMC – Federal Open Market Committee

SVB – Silicon Valley Bank

WTI – West Texas Intermediate

Russia-Ukraine conflict, for example, continues to result in sizable disruptions in food and energy sectors that could intensify quickly and with little to no warning. Over the last year, crude oil prices have fallen 25% from $100.28 to $74.81 and agricultural commodities such as wheat and corn have fallen 31% and 11%, respectively. However, much of the price relief last year was the result of unseasonably favorable weather in many parts of the globe as well as Russia's concession to allow at least a portion of the grain and fertilizer exports needed to feed millions of people around the world and stabilize markets.

As spring approaches, the snow is melting and the key summer driving season is upon us, which could push crude prices higher. The change in seasons also marks the primary planting season across much of North America. This year, farmers face a growing challenge to offset losses from Ukraine and Russia, the *"breadbasket of Europe,"* as well as increased flows of fertilizers, food and energy commodities to China as opposed to less friendly countries supporting Ukraine. Additionally, last week Russia affirmed it has agreed to extend an export permission deal with Ukraine for 60 days rather than a previously offered 120 days. Moscow has also threatened to scrap the deal altogether if *"conditions"* aren't met.

Any further imbalance of international commodity markets will only exacerbate global limitations and supply-side price pressures, further complicating the pathway for domestic – and global – monetary policy.

THE LONG GAME

The latest commentary from the FOMC suggests the peak in the fed funds rate may be somewhat lessoned from previous expectations if in the aftermath of the recent banking *"crisis"* credit conditions tighten. Looking at policy firming as a combination of both monetary policy measures as well as an adjustment to organic credit conditions, the nominal level of rates may be reduced by anywhere between 25-100 basis points from earlier, pre-SVB estimates.

However, even after the Fed declares policy *"sufficiently restrictive"* to rein in demand-side price pressures, the Committee may be forced to keep policy at or near a peak level for longer than anticipated if supply-side constraints remain. After all, even with the battle against demand-side pressures presumably won, there is no guarantee that inflation will recede as monetary policy has little control over supply-side pressures.

The Fed has been clear in its focus on taming inflation. As we all know, the economy does not work for anyone without price stability. Such a goal, however, remains complicated by international unrest and the looming debt-ceiling crisis here at home. Even with demand-side price pressures satisfied, the Fed may be forced to keep policy at a less accommodative level than the market is currently willing to acknowledge.

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