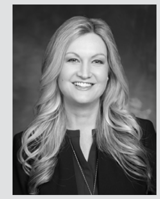
June 26, 2023

# A Message of Renewed Focus: Federal Reserve Members Anticipate a Moderate Pace of Further Rate Hikes to Tame Inflation

Economic **INSIGHT**

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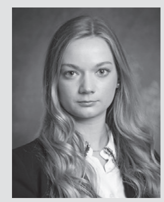

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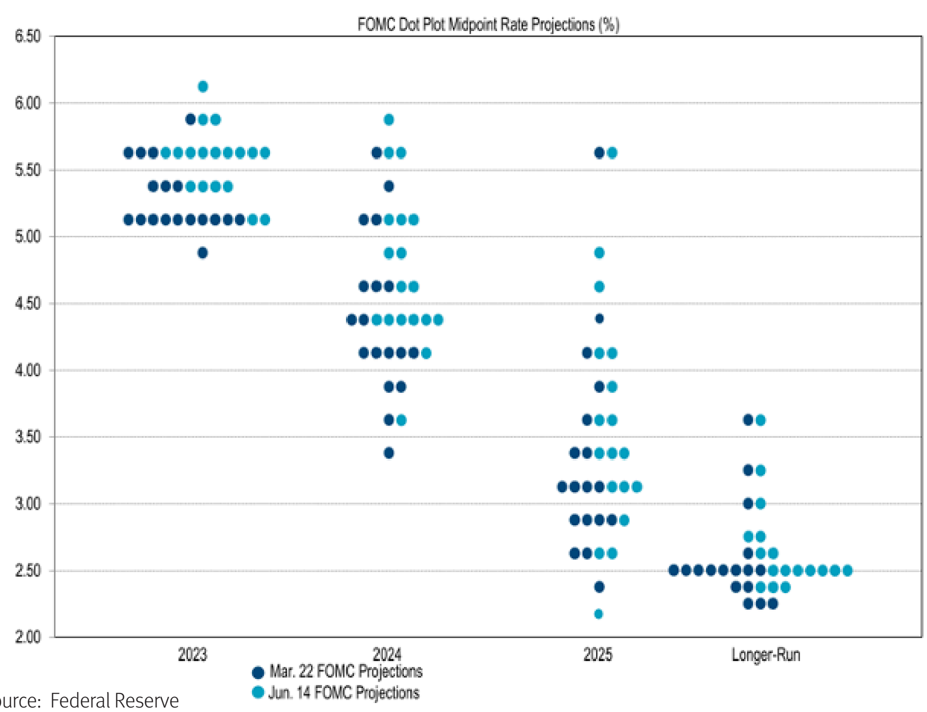
The Federal Reserve (Fed)'s message this month was clear, crystal clear: The Federal Open Market Committee (FOMC)'s decision to pause rate hikes in June should be considered a temporary halt and in no way an indication of an end to policy tightening. In fact, as Fed Chairman Jerome Powell noted in testimony on Capitol Hill this week, "*nearly all FOMC participants expect that it will be appropriate to raise interest rates somewhat further by the end of the year.*" The Fed's assessment of the economy both in the June statement and Powell's testimony was relatively upbeat, noting a strong economy and "*robust*" job gains amid a "*sound and resilient*" financial system. Inflation, however, remains "*elevated*," well above the Fed's target. As such, there is clearly more work to be done.

The notion of a one-month "*skip*" was well established prior to the official June policy announcement. Ahead of the meeting, even those Fed officials in support of a pause noted the need for further Fed action as early as July. Such a message was delivered with a seemingly simple tweak to the statement, adjusting from earlier language stating the "*extent to which additional policy firming may be appropriate*" to the "*extent of additional policy firming that may be appropriate.*" A slight but important differential with the latter clarifying the need for additional tightening, although how much more remains uncertain.




Source: Federal Reserve

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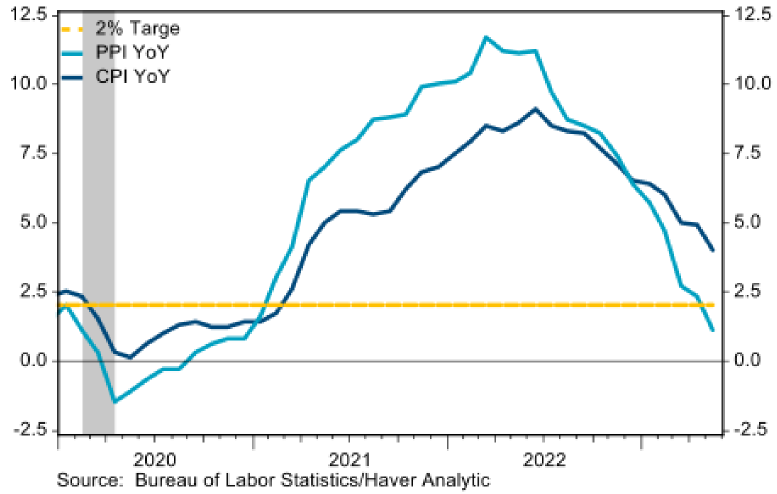
Despite some pockets of weakness or ongoing concerns in financial markets, reinstating price stability remains the Fed's primary focus. As Fed Governor Christopher Waller noted following the June FOMC rate announcement, officials shouldn't allow concern about a few lenders to get in the way of the fight against inflation. "*I do not support altering the stance of monetary policy over worries of ineffectual management at a few banks,*" Waller said. Of course, that doesn't mean the Fed can look the other way or ignore the need for updating its supervision and regulatory practices amid further market sensitivities. Nor does it imply rate hikes will resume its previous quarter-point hike at every meeting pace. "*Given how far we've come, it may make sense to move rates higher, but to do so at a more moderate pace,*" Powell said during his testimony to Congress.

Nevertheless, policy makers have notably increased their expectations for the terminal level of policy over the past month(s). According to the updated Summary of Economic Projections (SEP), the median estimate rose 50 basis points (bps) from 5.1% to 5.6%, with three members now in the 5.75-6.25% camp. Pushing against market expectations of a potential first round cut as early as December, the Fed has been clear rate cuts are not in the base case forecast, instead perpetuating the notion of higher for longer.

**KEEP YOUR EYE ON THE – INFLATION – BALL**

Of course, while the latest inflation data may not have tempted the Fed to reverse course on a pause this month, the data remains far from sufficient to justify a prolonged position on the sideline. The latest May inflation data indicates the trend of disinflation remains well established, however, the painfully slow pace of improvement gives little credence to the notion the Fed has done enough to adequately tame inflation. If the Fed maintains the goal of reinstating price stability, there is clearly more work to be done.



Source: Bureau of Labor Statistics/Haver Analytic

In May, the Consumer Price Index (CPI) rose 0.1%, cooling from a more robust 0.4% increase the month prior. Year-over-year, consumer prices rose 4.0%, down from the 4.9% pace reported in April, the 11th consecutive month of waning momentum from a peak of 9.1% in June last year and lowest level since March 2021. Meanwhile, the core CPI, which excludes food and energy, also decelerated on an annual basis, slowing from 5.5% to 5.3%. On a monthly basis, however, the key gauge of prices accelerated 0.4% for the third consecutive month.

Among the largest drivers of May inflation came from used cars and trucks, clothing, and shelter costs. Shelter costs alone, which account for 35% of the CPI index, rose 0.6% in May after a 0.4% rise the month prior. On the other hand, the cost of airline travel, energy, and commodities declined. Gasoline prices fell 5.6% for the month, off more than 6% since the start of the year.

**GLOSSARY**

**CPI** – Consumer Price Index

**FOMC** – Federal Open Market Committee

**PCE** – Personal Consumption Expenditures

**SEP** – Summary of Economic Projections

**YoY** – Year over Year

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Producer prices, meanwhile, have been less indicative of a sustained inflationary threat in the U.S. economy, reverting back below the Fed's 2% target as of late. Reflecting an increased appetite for services over goods in the aftermath of the pandemic, as well as increased or restored fluidity in global supply chains, goods costs have shown vastly more improvement in restraining inflation.

The May Producer Price Index (PPI), for example, posted an outright decline, down 0.3% month-over-month. On an annual basis, producer prices rose 1.1%, the smallest annual gain since December 2020. Of course, the majority of the headline weakness was centered on food and energy costs down 1.3% and 6.8%, respectively. Excluding food and energy costs, the core PPI rose 0.2% and 2.8% year over year.

## POLICY DIRECTIVES

Taken together, the Fed's latest policy announcement, Powell's testimony of a solid assessment of conditions and stronger-than-expected economic data raises two key questions. First, if the Committee is convinced the U.S. labor market and consumer, and by extension the broader economy, will remain modestly robust and additional policy actions are needed, why pause rate hikes now, even if only for one month? According to the FOMC statement and Fed commentary, the temporary stay in policy allows Fed officials to fully assess economic conditions that remain stronger than expected, but are still uneven. "*Holding the target range steady at this meeting allows the Committee to assess additional information and its implications for monetary policy,*" the June FOMC statement read. In other words, while the data at this point does not necessarily support even a temporary halt to rate hikes, the anticipation of worsening conditions as a result of earlier policy action coupled with uncertainty, particularly in the banking sector, warrants a slower pace of still more rate hikes to come.

"*But at last week's meeting, considering how far and how fast we have moved, we judged it prudent to hold the target range steady to allow the Committee to assess additional information and its implications for monetary policy.*" – Federal Reserve Chairman Jerome Powell, Semi-Annual Policy Testimony to Congress, June 21, 2023

This leads to a second set of questions regarding stubbornly elevated prices. Why, after 500 bps in policy firming, does inflation remain so high? Why hasn't Fed policy had a more meaningful impact on price pressures? Should the Fed simply exercise more patience as it did in June for the lagged impact of earlier policy and strains posed on the banking system, or should it stay the course until there is more meaningful and realized improvement?

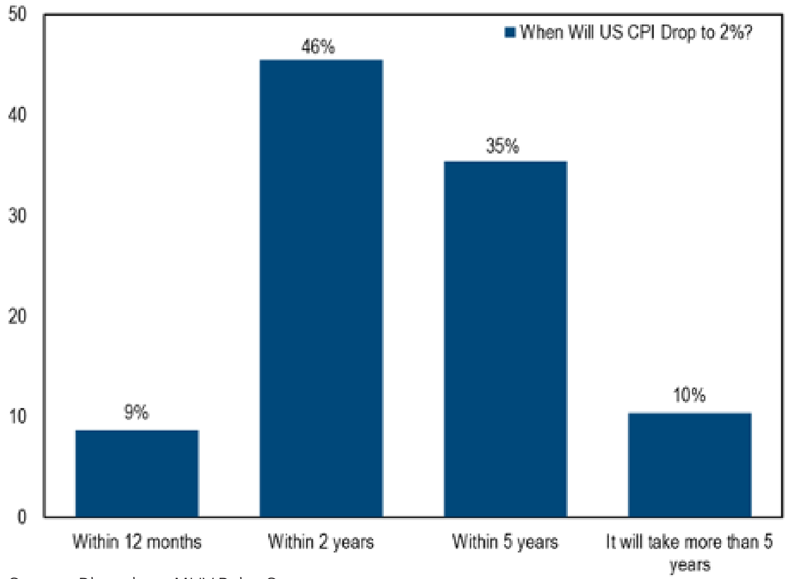
In part, the answer lies in the presumed lag in policy as well as the organic nature of inflation that was spurred during the pandemic and its immediate aftermath. While historically Fed officials have assumed a sizable timeline between the implementation of monetary policy and the real effect on economic conditions, many argue such a gap has been greatly diminished with a growing level of transparency in the policy-making process. With a Summary of Economic Projections (SEP) four times a year, a press conference at every meeting, not to mention ample commentary and Fed-speak from a plethora of officials, this has arguably led to an anticipatory nature of financial market conditions. Meaning, the Fed's next move(s) are largely already priced into the market often before they are made official because policy makers have been clear in the pathway for policy. Which is to say, if in fact there is a diminished period between action and effect of Fed policy, the minimal effect on prices to date should force the Fed's hand to step back up to the plate sooner than later.

Furthermore, as expected, the lack of meaningful improvement in inflation thus far reflects the complicated nature of the beast created during the pandemic. The unprecedented nature of the policy response, including global supply chain restraints and dislocations and the unprecedented surge of fiscal stimulus totaling trillions and trillions – and trillions – of dollars has resulted in price pressures of all kinds, some of which are beyond the Fed's control. Supply-side inflation, wage inflation, demand-side inflation, or what some have deemed greed-flation, have resulted in the widest profit margins in decades (this also helps to explain the varying spread between the PPI and CPI). While the Fed can raise the cost of borrowing to tamp down investment and consumption, there is little policy makers can do to control corporate policy or broker international peace. In essence, the Fed, as Powell has noted in the past, cannot print more ships.

With plenty of blame to go around, one of the worst bouts of inflation in four decades has many Americans on Wall Street – and Main Street – looking for answers *and* a solution.

## CONFIDENCE THE FED WILL RETURN

The latest inflation data – devoid of an upside surprise – coupled with still ongoing whispers of lingering market stability concerns was enough to push the Fed to the sideline earlier this month to assess and gauge market conditions. Nevertheless, the lack of meaningful improvement in price pressures falls well short of definitive evidence that the Fed can or should take an extended stay in policy. Down from a recent peak, prices are still rising, and consumers are still losing purchasing power as they have been for the better part of two years. While consumers are still spending – a show of surprising staying power and a welcome support to a still-expanding economy – the difference now is that as consumers continue to curtail purchases, households are also beginning to lose faith in the Committee's commitment and ability to reinstate price stability.



Source: Bloomberg MLIV Pulse Survey

According to the latest Bloomberg Markets Live Pulse survey, more than half of participants anticipate it may take longer than 2 years to reinstate the Fed's goal of prices stability and 10% fear it could take more than five years.

Looking back to the 1980s, inflation rose to a peak of 11.6%, forcing then Federal Reserve Chairman Paul Volcker to raise rates to a peak of 20% in March 1980 and again in May 1981. Of course, if history is a guide, Powell's Fed should be weary not to repeat earlier policy missteps. In part, the loss of control over inflation decades ago was spurred by a loss of confidence in the Fed's focus and willingness to tame inflation. As such, inflation expectations surged to over 10% by January 1980. Furthermore, losing its resolve, Volcker's Fed backed away from additional rate hikes in March 1980, only to renege five months later with the inflation dragon far from slain.

While further Fed tightening this time around will likely – again – result in a downturn in topline growth if not an outright recession as it did decades ago, it is important for the Fed to keep its eye on its inflation goals and force the American economy and people to take their proverbial medicine now. Any failure to raise rates to a sufficiently restrictive level could allow inflation to become engrained into the market, forcing the Fed, like Volcker, to reengage in a second round of tightening. This could potentially force policy makers to raise rates higher and push the economy deeper into contraction than arguably would otherwise be necessary should officials stay the course the first time around. A one-month pause is not enough to derail progress already made, but the Committee needs to return to action sooner than later.

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