October 24, 2023

Economic INSIGHT

A Federal Reserve Divided Unto Itself

Lindsey M. Piegza, Ph.D.
Chief Economist
piegzal@stifel.com

Lauren G. Henderson
Economist
hendersonla@stifel.com

As uncertain as war itself, so too is the impact of international conflict on monetary policy. With that in mind, the best answer to *"How will the Israeli conflict impact the Federal Reserve (Fed)'s plans for interest rate policy?"* is it's too early to tell. It's too early to draw a conclusion or to interpret the last two weeks of events. In fact, it's too soon to even separate the geopolitical and humanistic implications from the potential global economic or domestic impact. And certainly, it's too soon to entirely digest or forecast the directional pressure it could exert on monetary policy.

Widespread conflict coupled with an erosion of international growth could delay or entirely remove the Fed from taking further steps. A resurgence of inflation, meanwhile, as a result of higher oil prices – or other commodity disruptions – could have the opposite effect, prompting additional Fed action.

HIGHER RATES OFFER ASSISTANCE TO THE FED

Uncertainty, higher long-term rates, and weaker global growth forecasts – including reduced expectations for domestic activity – could prompt the Fed to position itself on the sidelines sooner and for longer than previously anticipated. Potentially replacing a skip-reengage pattern, some officials have called for a longer pause or outright conclusion to rate hikes. Policymakers in this camp are convinced that additional policy firming is neither necessary nor appropriate, given the recent events overseas and the subsequent reactions in the marketplace.

Of course, much of the argument for tapering future policy action has been predicated on the success in reducing inflation and a rally in long-term rates. In fact, according to Dallas Fed President Lorie Logan, it is precisely the recent backup in rates that may preclude the Fed from having to raise rates further. *"If long-term interest rates remain elevated because of higher-term premiums, there may be less need to raise the fed funds rate,"* Logan said.

While higher rates or tighter financial credit conditions may assist the Fed in achieving its goal of price stability, market conditions remain uncertain and unstable, particularly as events unfold in the Middle East. This suggests the onus remains – and should remain – on the Fed to forcefully and persistently tame price pressures. The Committee's mandate will not be satisfied with a *temporary* reduction in inflation. Furthermore, any *"reversal"* in the recent rise in yields, with greater demand for 10- and 30-year Treasuries led by a flight-to-quality trade, would negate support for a more passive Fed.

STIFEL

Alternatively, the recent rally in rates itself may do less to alleviate pressure on the Fed and simply compound the need for additional action, supporting the notion of a more aggressive – not an inactive – Fed. Minneapolis Fed President Neel Kashkari, for example, concluded that if the recent rise in Treasury yields is a reflection of a market adjustment in expectations for Fed policy, *"we [the Fed] might actually need to follow through on their expectations."* In other words, if higher rates are the catalyst for a further reduction in inflation, then the Fed needs to continue to raise rates to ensure the market's reaction is ongoing.

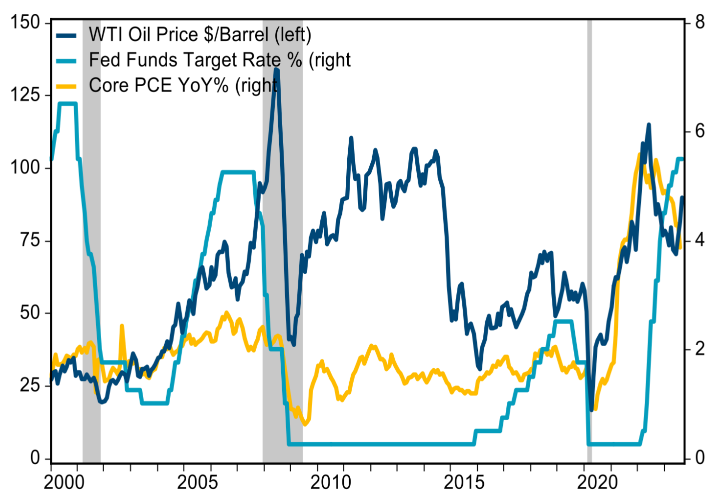
FURTHER PRICE PRESSURES

The Fed has made considerable progress reducing prices pressures. The core Personal Consumption Expenditures index has fallen from a peak of 5.6% in February 2022 to 3.9% in August 2023. However, looking from a *"glass half empty"* perspective, inflation is still nearly double the Fed's intended target even after 525 basis points in rate hikes. With the most recent trend in headline inflation reversing course since July, further price pressures or upside price shocks – be that from food, energy, fertilizer – if *sustained*, could seep through, causing additional core price growth and the need for a firmer stance from the Fed.

Early analysis suggests the impact of the Israeli-Hamas conflict will have a more muted impact on global supplies, at least relative to that of the Russia-Ukraine War. Russia, after all, is a top energy producer (#3) and fertilizer producer (#1), and Ukraine is a key exporter of wheat (#5) and sunflower seeds and oil (#1). That being said, the global economy remains delicate, and challenges to growth, the markets, and central bank policy will persist.

Monetary officials are unlikely to adjust rates based on a *temporary* uptick in prices, particularly energy costs. This is why the central bank focuses on core inflation, which excludes the more volatile components of food and energy. Meaning a *temporary* move would warrant a return of a *"transitory"* assessment.

The rally in oil prices, however, began at the start of the summer and has continued as the Israeli conflict entrenches itself. Thus, the persistent nature of rising prices is threatening to result in an increase in core price pressures. If sustained, it could renew fears of higher inflation and compound the need for tighter policy in the quest of price stability. To be clear, the Fed would not need to indefinitely raise rates if energy or other supply-side costs outside of the Fed's purview remain above trend, but lingeringly high prices support the idea of maintaining an elevated level of rates for longer than previously expected.



Sources: EIA/CME, FRB, BEA/Haver

GLOSSARY

PCE – Personal Consumption Expenditures

WTI – West Texas Intermediate

YoY – Year over Year

STIFEL

A BROADER PERSPECTIVE

Often driven by impatience or a lack of clear data, market participants – and officials alike – have grown accustomed to kneejerk reactions in response to economic news and events. The level of uncertainty, however, in today's rapidly changing and evolving geopolitical environment with unprecedented political and fiscal risks has resulted in *consistent over* – and under – reaction. Frequent unsupported movements – i.e. too many *"head fakes"* – in a short period of time can often cause a larger misread of the data and more importantly risk an unjustified policy response.

Lindsey Piegza
Ph.D., Chief Economist
piegzal@stifel.com

DISCLAIMER

This material is prepared by the Fixed Income Strategy Department of Stifel, Nicolaus & Company, Incorporated ("Stifel"). This material is for informational purposes only and is not an offer or solicitation to purchase or sell any security or instrument or to participate in any trading strategy discussed herein. The information contained is taken from sources believed to be reliable, but is not guaranteed by Stifel as to accuracy or completeness. The opinions expressed are those of the Fixed Income Strategy Department and may differ from those of the Fixed Income Research Department or other departments that produce similar material and are current as of the date of this publication and are subject to change without notice. Past performance is not necessarily a guide to future performance. Stifel does not provide accounting; tax or legal advice and clients are advised to consult with their accounting, tax or legal advisors prior to making any investment decision. Additional Information Available Upon Request.

Stifel, Nicolaus & Company, Incorporated is a broker-dealer registered with the United States Securities and Exchange Commission and is a member FINRA, NYSE & SIPC. © 2023

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST 1023.6037650.1