Economic **INSIGHT**

November 13, 2023

Mind Your Cutlery: Despite Market Skepticism, Elevated Inflation Could Drive Rates Higher

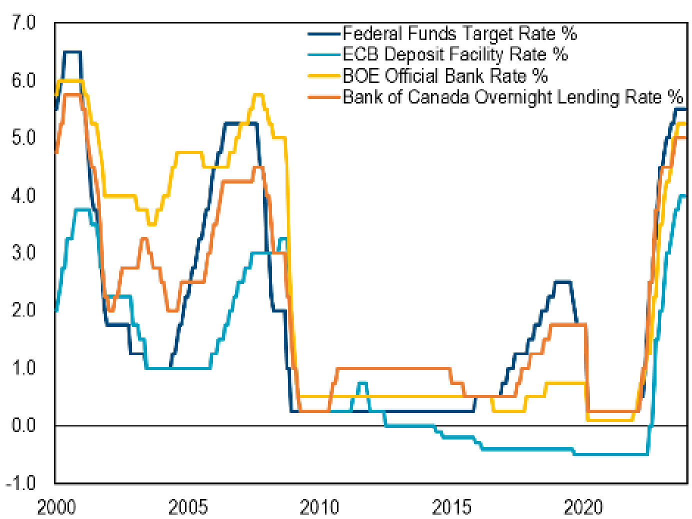
The Federal Open Market Committee (FOMC) opted to leave rates at an upper bound of 5.50% earlier this month as they have been since July, sparking speculation the Federal Reserve (Fed) may be done with rate hikes altogether. In fact, following the weaker-than-expected October employment report, many on Wall Street began ramping up expectations for rate cuts next year both in number and brevity.

It still may be premature, however, to get out the proverbial fork, and stick it in the Fed. After all, while many consumers and businesses are understandably anxious for capital cost relief following the fastest acceleration in rates in four decades, the data aren't yet convincing that price stability is a sure thing or that the Fed has done enough to ensure its mandate is met. While ample progress from peak levels has been made, there is still additional ground to cover. In fact, according to Minneapolis Fed President Neel Kashkari, the Fed isn't even thinking about thinking about rate cuts.

Monetary policy is a blunt instrument, and trying to be too precise with policy in the attempt to achieve the utopic soft landing that has alluded far too many Fed chairmen in the past could be problematic. When addressing strong inflationary pressures, the risk isn't raising rates too much, it's not raising them enough to completely slay the inflation dragon. *"Undertightening will not get us back to 2%,"* Kashkari, told The Wall Street Journal on Monday. While the economy has been resilient, there are ongoing concerns of inflation *"ticking up again."*

THE LATEST FROM THE FED

Following a similar move from a plethora of global central banks, such as the European Central Bank (ECB), the Bank of Canada (BOC), and the Bank of England (BOE), the Fed opted to keep rates steady at a range of 5.25-5.50% for the second consecutive meeting. Widely expected to remain on the sideline, this now



Source: ECB/BOE/BOC/Federal Reserve/Bloomberg

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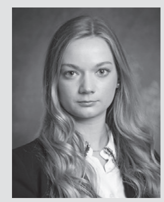

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marks the longest pause (4 months) since before the initial March 2022 rate hike. This has sparked speculation that the Fed may be done with rate hikes altogether.

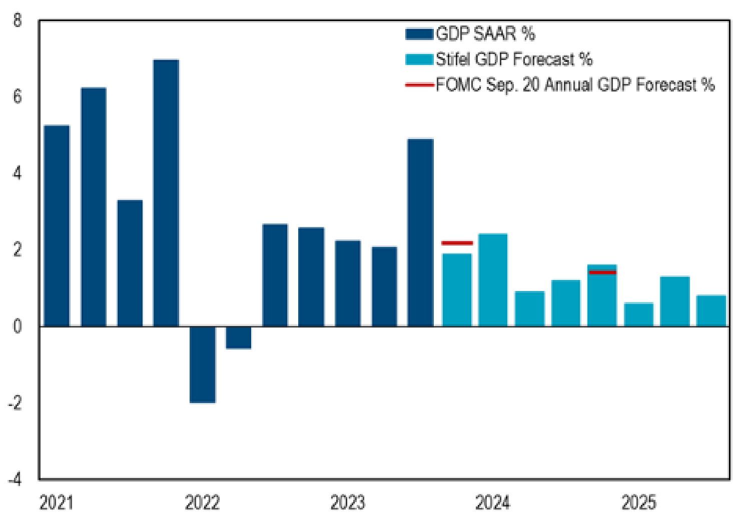
While historically the Fed does have a more difficult time reengaging after a prolonged stay in policy, the data do not yet support the conclusion that policy is sufficiently restrictive. As Fed Chairman Jerome Powell noted during a speech on Thursday, the Fed is not yet assured it has reached a sufficiently restrictive level. Speaking at an International Monetary Fund event, Powell said, *"We know that ongoing progress toward our 2 percent goal is not assured: Inflation has given us a few head fakes. If it becomes appropriate to tighten policy further, we will not hesitate to do so."*

Additionally, the November FOMC statement clearly indicates at least a willingness to hike again if inflation concerns remain. Maintaining the language of *"determining the extent of additional policy firming that may be appropriate,"* the Committee was clear it is not a question of if, but rather when and by how much?

"Additional evidence of persistently above-trend growth, or that tightness in the labor market is no longer easing, could put further progress on inflation at risk and could warrant further tightening of monetary policy."

– Federal Reserve Chairman Jerome Powell, November 1 FOMC Press Conference

Of course, a willingness to act does not imply certainty of action. Rather with a data-dependent position, as it implies, policy decisions will be dictated by the evolution of the performance of inflation and the underlying economy. The problem is, by the Fed's own assessment, the data continue to support the call for further tightening despite the Committee's – temporary – hesitation.



Source: Bloomberg/Federal Reserve Board/Stifel

In its assessment of the economy, the Committee characterized economic growth as *"strong,"* a noticeable upgrade from *"solid."* The increased positivity is no doubt a reflection of a surge in activity in the third quarter with GDP reported near 5%, the fastest pace since fourth quarter 2021. Driven by an ongoing and surprisingly resilient consumer, consumer spending rose 4.0%, following a 0.8% rise in the second quarter, marking the strongest six months of expenditures since the start of the year.

The Fed also extended its robust description of conditions turning to the labor market. The Fed continues to describe job gains as *"strong,"* as it has since September. Of course, after jumping 296,000 in September, the strongest monthly gain since January, payrolls rose just 150,000 in October, falling well short of expectations at a near three-year low. Smoothing out volatility, however, hiring momentum remains firm above 200,000, with an unemployment rate that is slowly ascending but still remains

GLOSSARY

BOC – Bank of Canada

BOE – Bank of England

CPI – Consumer Price Index

ECB – European Central Bank

FOMC – Federal Open Market Committee

GDP – Gross Domestic Product

SAAR – Seasonally Adjusted Average Rate

SEP – Summary of Economic Projections

WSJ – Wall Street Journal

YoY – Year over Year

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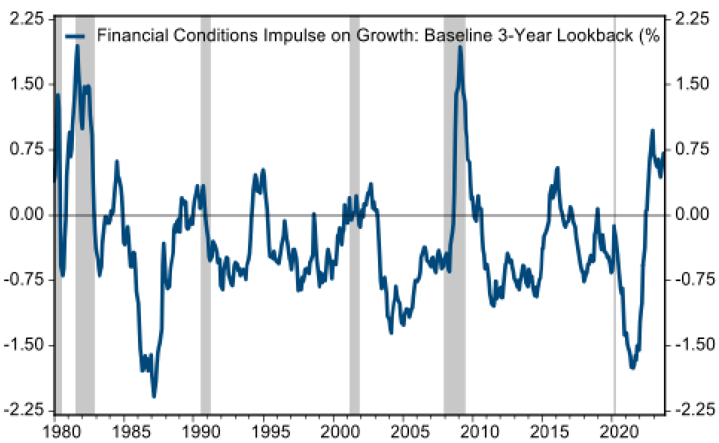
near a five-decade low.

INFLATION *"ELEVATED"*

The questions remains, if the Fed is clear there will – eventually – be additional policy firming, or at the very least additional policy action is a possibility, and at present the economy remains on relatively firm footing, why the hesitation? Why not continue to move forward with further rate hikes sooner rather than later?

In part, the Fed is convinced the lag between monetary policy and the real effect on the economy is still – as it has been historically – long and variable. Of course, with the unprecedented amount of transparency in terms of policy deliberation, including a Summary of Economic Projections (SEP) four times a year, a press conference at every meeting, and ample Fed officials taking the stage to explain in further detail the directional momentum of policy, financial markets have adopted an anticipatory nature of conditions. Meaning, Fed policy decisions are priced in before they are even announced, potentially – and significantly – reducing the lag effect.



Source: Federal Reserve Board/Haver Analytic

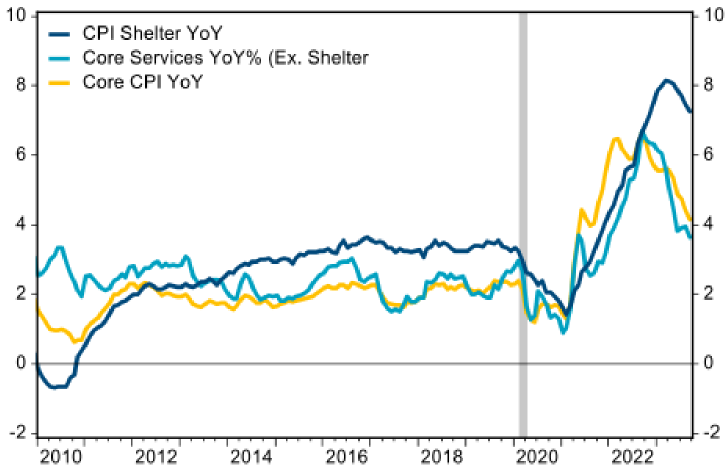
The Fed's own financial conditions index released earlier this year indicates the impact of tightening peaked in December 2022, suggesting as of September the incremental drag on activity has greatly dissipated. If accurate, the lack of clear downward momentum in inflation may require a stronger monetary policy stance.

Additionally, as seen in the November FOMC statement, the Fed acknowledged a change in market conditions and how these factors may downplay activity. *"Tighter financial and credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation,"* the statement read. The Committee remains attentive in particular to higher longer-term yields. The implications for monetary policy, however, are based on the *"persistence"* of such changes. In other words, an adjustment in rates based on structural factors, such as fiscal deficits, would offer lasting assistance to the Fed in terms of achieving inflation that is more benign. However, if an adjustment higher in rates is based on changing expectations for Fed policy, then the Committee may be forced to follow through with additional policy adjustments in order to achieve higher rates on a more sustained basis.

ONE MORE UNTIL NEXT YEAR

The market continues to digest the latest Fed policy decision against the backdrop of ongoing solid data seemingly growing the divide between those convinced the Fed has done enough and those still calling for a firmer – or at least stable – policy stance. In fact, after raising rates 525 basis points in less than two years, investors are questioning Chair Powell's commitment of staying the course *"until the job is done"* with some on the Committee catching a more severe case of cold feet, questioning the 2% inflation target altogether.

Inflation has made considerable progress, slowing from peak levels, but we're not there yet. There remains a sizable distance from achieving 2%, and with upside risks stemming from core services (excluding shelter) as well as energy or other commodity costs amid international uncertainty, now is not the time for the Fed to lose resolve or overly soften its policy stance.



Source: Bureau of Labor Statistics/Haver Analytics: BLS, BLS/

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