March 20, 2023

Economic INSIGHT

Systematic Breakdown vs. Individual Failures, and the Pursuit of Price Stability

The latest read on inflation showed price pressures remain elevated, still well above the Committee's preferred 2% range. Disinflation continues, although the pace of waning momentum has slowed markedly with consumer price growth stubbornly at 6%. Thus, from an inflation standpoint, there remains solid support for the Federal Reserve (Fed) to continue to raise rates in an effort to reinstate price stability.

Of course, for monetary officials, policy decisions are never black and white nor are they made in a vacuum without a broader assessment of the economy and market conditions. In the wake of the recent failures of Silicon Valley Bank (SVB) and Signature bank igniting fears of systemic weakness in the U.S. banking sector, the Committee faces a conundrum: remain on a pathway to higher rates in an effort to thwart inflation, or "ease up" given the negative impact higher rates are seemingly having on the banking sector?

The Fed has already increased rates 450bps since March of 2022, and finally something "broke." Or did it? Is there a budding crisis, or is the market conflating a systematic breakdown with the failure of individual institutions? The answer has a significant impact on the upcoming policy decision and subsequent initiatives thereafter

INFLATION, INFLATION, INFLATION!

With the next FOMC meeting now just five days away, the latest read on prices was of particular importance as the final key data point before Wednesday's rate announcement. Despite already eight rounds of tightening, inflation, while off earlier highs, remains stubbornly elevated at more than double the central bank's target range (or more depending on one's preferred measure of prices). While the Fed does not need inflation to reach 2% before backing off, with the pace of disinflation slowing, the data have yet to convince Fed officials inflation is on a meaningful and sustainable downward trajecthe start of the year and marking the eighth consecutive month of waning momentum, inflation remains elevated at 6.0%.

Excluding food and energy prices, the core CPI, meanwhile, rose 0.5%, slightly more than expected and "only" pulling the annual pace down one-tenth to 5.5%.

Producer price pressures, on the other hand, unexpectedly fell, dropping 0.1% for the month of February, following a 0.3% rise the month prior. The PPI was expected to increase 0.3%. Year-over-year, producer prices rose 4.6% in February, markedly less than expected, and down from the 5.7% increase in January.

Excluding food and energy costs, the core PPI was flat (0.0%) following a 0.1% increase

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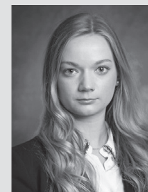

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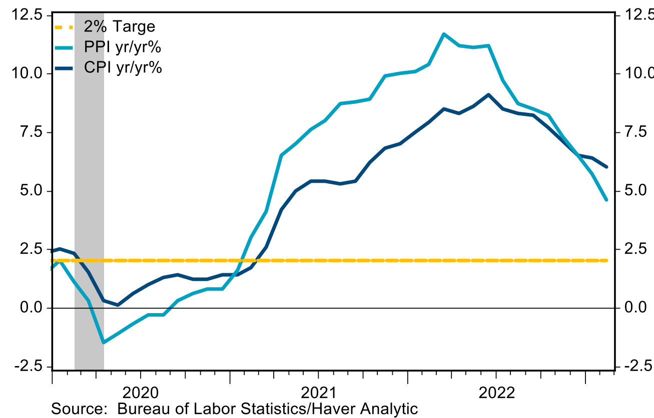
in January and well shy of expectations. The annual pace of core producer prices also showed no further improvement, holding steady at 4.4%.

The juxtaposition between February's warmer-than-expected consumer inflation report and the cooler-than-expected producer price report is a welcome reminder of the difficult and complicated war the Fed is waging on inflation. While noticeably off earlier peak levels, price pressures remain elevated with an uncertain pathway forward. For months, the Fed has been clear in its intentions to raise rates high enough to slay the inflation dragon, but such a mission is not clear cut nor without casualties, a reality more difficult to ignore in recent days.



If price stability remains the Fed's primary goal, even with temporary distortions, volatility or additional "pain," then the central bank likely still has work to do. In fact, the Fed has reiterated numerous times that the risk of undershooting is significantly greater than overshooting, as the latter could be corrected quickly with a series of rate reductions. Although, a potentially sizable and variable lag in the effect of earlier rate hikes could mean the Committee has been more successful in taming the inflation beast than currently indicated, given the backward-looking nature of the data.

GO BIG OR GO HOME – NOT IN THIS CASE

While many remain concerned over contagion fears following the recent banking institution failures, the Fed appears convinced broader financial conditions remain "resilient and on a solid foundation." In fact, given the Fed's earlier hawkish positioning and opening the door for a potential 50bp increase next week, the Committee would seemingly be mistaken to depart with its earlier established pathway to a higher rate policy amid the still elevated level of inflation. At the very least, the central bank's credibility or competence may come into question if officials failed to follow through with a further policy adjustment come Wednesday.

Of course, that being said, while ongoing rate hikes do appear appropriate and necessary, acknowledging the recent turmoil and lingering investor unease, as well as focusing on financial market stability, the Committee is unlikely to "push the envelope" by reverting back to a larger sized hike. But while the market is convinced that a 50bp increase is no longer on the table with the probability of such falling from 79% on March 8 to 0% as of March 14, the question of any size hike remains. As of March 17, the market continues to assign a 29% probability to the first pause in the Fed's tightening cycle in 12 months.

TO HIKE OR NOT TO HIKE

There certainly is an argument for the Committee to avoid not only ramping up the size of rate hikes, but also potentially pausing altogether. After all, market risks still remain. As many talking heads have stated over the last few days where there is one cockroach there are often many more. As such, other banks, financial institutions, and holders of

GLOSSARY

FOMC – Federal Open Market Committee

CPI – Consumer Price Index

PPI – Producer Price Index

YoY – Year over Year

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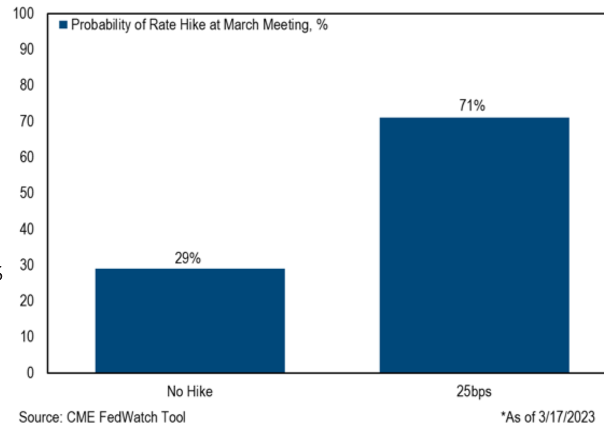
longer-dated Treasury securities could face similar issues or hardship. Thus, a pause in additional tightening would presumably offer a welcome reprieve for banks and allow the Fed to assess more closely the turmoil that some argue was a direct result of earlier monetary policy decisions – raising rates at the fastest pace in four decades.

Of course, as more institutions fear a similar fate of SVB and perhaps recognize their own shortcomings, whether self-imposed or the result of reinvigorated regulators, tighter lending standards may emerge. If realized, higher standards could act to aid the Fed reach its goals of tamping down investment and consumption, resulting in a slower growth rate and more benign inflation. Ultimately, fear resulting in tighter lending limitations could help to do some of the Fed's work and reduce the peak level of rates needed to reign in inflation and the level of distress shouldered by financial institutions.

Alternatively, a lack of action by the Fed at the March meeting could itself serve to exacerbate market uncertainty with participants already pricing in a 25bp hike with an 71% probability. Additionally, deviating from the earlier suggested policy decision, now less than a week away, could send a signal of unnecessary concern. After all, if the market is safe and sound with the crisis averted and minimal risk of contagion as officials profess, as inflation remains a sizable threat, why wouldn't the Fed continue to hike as earlier indicated, unless the Committee was more concerned about financial markets than they are willing to admit.



Source: CME FedWatch Tool *As of 3/17/2023

Additionally, the Fed's new liquidity facility offers a greater ability for the central bank to continue to raise rates by helping to remove or at least offset some of the added pressure on institutions as a result of higher rate policy. The Committee also has the option to offer additional liquidity initiatives as needed, such as dollar swap lines or other measures, as the Committee moves closer to the terminal rate, allowing the Fed to reinstate stability and confidence in the banking sector while remaining focused on its longer-term goal of price stability. In other words, perhaps the Fed can have its cake and eat it too, at least depending on the depth and duration of the market's reliance on alternative lending facilities. After all, an increase in liquidity is likely to accelerate or fuel the very inflationary pressures the Fed is seeking to tamp down.

QUITE THE CONUNDRUM

The Fed is facing quite the conundrum, walking a delicate line to keep financial markets stable, while attempting to impose "sufficiently restrictive" policy to tame inflation, the latter of which will ultimately add more turmoil to the banking sector the Committee aims to keep resilient. A lack of action to quell inflation could allow price pressures to become entrenched, eventually destabilizing the economy and with it the banking sector – and every other sector of the economy. Of course, with inflation decelerating from earlier peak levels, perhaps the Fed has already made significant headway in its quest to reinstate price stability, but is it enough?

The Fed has been clear that a period of pain is not only likely but also necessary in the pursuit of price stability. But how much pain can the U.S. economy withstand? How

much can the U.S. banking system withstand? Has either really experienced any pain as of yet? The U.S. labor market, after all, is “solid,” consumer spending is positive, and the banking system – while challenged in today’s rate environment – remains healthy.

With a rapid ascension in rates from 0.25% to 4.75% in the last 12 months, understandably some institutions have been caught off guard and ill prepared. Of course, for months the Fed has been clear – crystal clear – in its intentions to raise rates offering market players ample time to prepare, so arguably no institution should have been taken in a precarious state. That being said, the underlying question remains, how concerned are officials regarding recent events? Does the Committee view Silicon Valley Bank and Signature Bank as isolated incidents, or an indication of a systemic issue? Does swift action taken by the Fed to increase liquidity reinforce the sound nature of financial market conditions, or is this the first of many complications to emerge in the banking sector? Can the Fed continue to raise rates amid market unease?

Given the Fed’s blackout period ahead of next week’s FOMC meeting there has been little communication from the Committee. Thus, more than the rate announcement itself, this month’s press conference is likely to prove even more importatnt and lively as investors seek answers for key questions. But there is arguably no right answer or at least no perfect answer that the central bank can provide. Either pathway will be messy and likely result in a downturn if not outright recession for all. At this juncture, the Fed is simply trying to avoid the greater evil while ensuring a return to a longer-run pathway of stronger growth and stable prices. Fed officials – Chairman Powell himself – never said it was going to be easy, and if history is any indication, the last 100bps is always the most difficult and the most painful. But, the Fed has a job to do. Without price stability, “the economy does not work for anyone.”

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