Market News

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FED Up with Inflation

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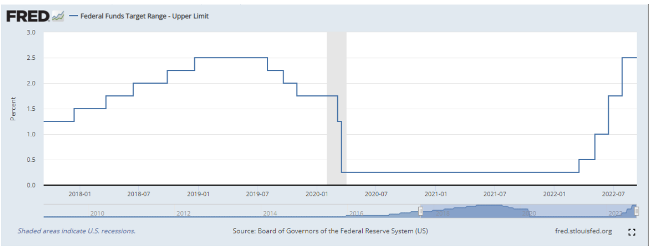
The Federal Reserve was created with the stated goal of using monetary policy to promote maximum employment and to stabilize prices in the US economy. It has been quite a while since the Fed has had to focus on the inflation side of this mandate, but stable prices have become the focus of Fed policy recently. The economy and financial markets are now faced with the challenge of quickly adapting to a change in Fed policy.

Historically speaking, inflation had been very low for the period following the great financial crisis. Arguably, the Fed spent a considerable part of this time more worried about deflation than inflation as they struggled to get inflation back to their target rate of 2%. However, as we exit the pandemic, the Federal Reserve is squarely focused on reining in the currently elevated levels of inflation.

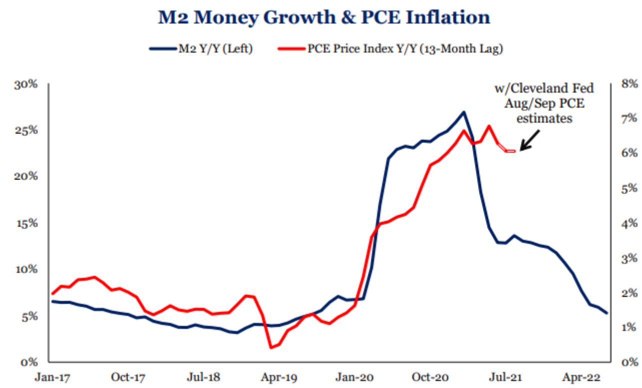
As with many things in economics, the issue of inflation is a function of supply and demand. When demand is greater than supply for a good or service prices are apt to rise. There are several expected and unintended consequences from policy responses relating to the pandemic that have contributed to the current imbalance. For example, the Federal Reserve's policies of low-interest rates and increasing the money supply combined with massive amounts of fiscal stimulus to boost demand. At the same time, the global effects of the pandemic disrupted supply chains and labor markets causing supply to fall as demand rose leading to inflation across the economy. A final factor in the rise of inflation was the disruption in energy markets that followed the Russian invasion of Ukraine.

While the Federal Reserve cannot directly impact all these issues, they are doing several things which should in time bring inflation down. The Fed's two main tools to control the economy and inflation are interest rates and money supply. These tools both directly influence the demand side of the economy over time. The challenge is that it is difficult to precisely forecast the timing or magnitude of the impact that of each of these will have.

Scott consults with TWM clients and relationship managers to implement their financial plans through building diverse portfolios of high quality, low-cost investments relative to individual goals. Scott helps clients to gain better understanding and peace of mind in a complex and often confusing world. He strives to bring patience and objectivity to the investment process on a daily basis in order to avoid the destructive impact emotional reactions can have on financial decisions. Scott joined TWM in 2006.

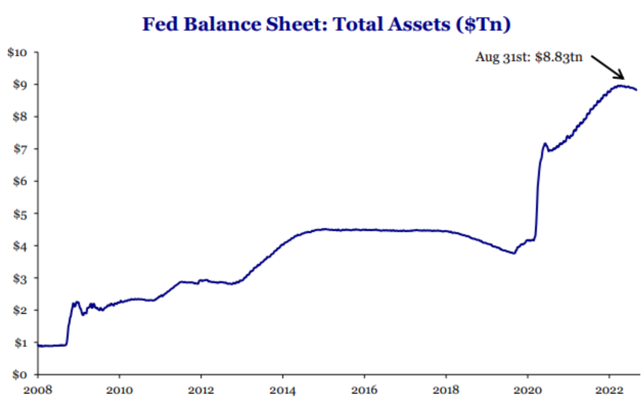


Interest rates are the most widely discussed tool when it comes to monetary policy. When the Fed raises interest rates, they are making money more expensive and this should have the effect of reducing economic activity as the cost of financing increases. Early this year the Fed began raising rates from near zero to the current rate of 2.5% (an additional 0.5% to 0.75% increase is expected in September). The speed of this increase compared to historical increases has been very quick and many think the Fed was behind the curve given the very high levels of inflation. As of now, the expectation is that the Federal Funds Rate will continue to rise throughout 2022. Economists have suggested 4-5% as a likely point for a pause in rate increases to gauge the impact.



The money supply has also contracted considerably this year. This has reduced the supply of money available in the system. The rate of money supply growth is very closely tied to economic growth and asset prices and tends to precede inflation.

The last action the Fed is employing, though more slowly, is reducing the size of its balance sheet by not reinvesting bond maturities and potentially selling bonds. This so-called balance sheet run-off will only hit full stride in October. This too will be a tool to help tighten monetary policy and slow the growth rate of the economy.



We are beginning to see the Federal Reserve gain some traction against those areas of inflation where it is most able to impact the economy. The sharp move higher in interest rates has certainly begun to have an impact on the prices of assets. Everything from stocks, bonds, and real estate to lumber, used cars, and copper have seen prices decline. While the rate of inflation is not yet at the target level, the direction of the move is encouraging.

One of the reasons the economy was able to perform so well during the pandemic was that both fiscal and monetary policies were working together to address the same problem. However, as we have begun to move beyond the pandemic, we have seen the coordination between these forces decline. Many have argued that the approximately $2 trillion in stimulus passed in 2021 was not needed and was the catalyst to move inflation higher. Similarly, the recently announced student loan forgiveness plan could translate into another $500 billion in stimulus further blunting the Fed's efforts. It appears the questionably named Inflation Reduction Act (IRA) will also add to inflation in the short-term.

The more challenging areas for the Fed to address are the supply chain issues, tight labor markets, and commodity prices. The Fed is most effective in addressing the demand side of the supply-demand equation and these problems are more supply based. We are hopeful that these issues will continue to improve and allow the supply side of the economy to grow. Should this occur, the Fed will be able to reach its goal without reducing demand too much or causing a prolonged period of economic weakness.

The Fed is on a mission to not only bring inflation down to its target levels, but also to rebuild its credibility as an inflation fighter. As a result, we believe they are likely to err on the side of doing too much versus too little. While this may be a challenge in the short-term, it likely is a good sign for the long term. During the early 1970's the Fed was too quick to declare victory against inflation and the result was persistent rebounds in inflation, eventually requiring more dramatic action to ultimately beat it. We are optimistic that current policymakers will not repeat these same mistakes, but we are aware that they may make new mistakes of their own.

We will continue to focus on striking a favorable balance between return and risk and be mindful that markets rarely move in a straight line and that short-term disruptions often create long-term opportunities. If you have any questions, would like additional information, or if you would like to speak with a member of our team, please contact us at 919.838.3221. Thank you for your continued confidence and the trust you place in our firm.

Source: Strategas Research Partners, LLC, Fred

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