Why The Fed Can't Fix Inflation

The Federal Reserve is clearly on a mission to tamp down inflation. When Chairman Jerome Powell recently announced a 75-basis point rate increase, it was a bigger hike than what he projected in May and also marked the biggest rate increase since 1994.

In Chairman Powell's words, "we are strongly committed to bringing inflation back down, and we are moving expeditiously to do so. We have both the tools we need and the resolve it will take to restore price stability on behalf of American families and businesses."

Part of the Fed's approach is to "front-end load" bigger rate hikes, in hopes that moving big and fast will solve the inflation problem sooner rather than later.[1]

But I'm not convinced the plan is going to work.

The reason is simple: inflation today is primarily a supply issue, and the Fed has no control over supply. Many would argue that years of easy monetary policy and massive fiscal stimulus programs created too much money and drove demand off the charts, a fair point. But these factors were more relevant in 2020 and 2021, in my view, and in normal times I believe the global economy could have absorbed this surge in demand.

But 2020 and 2021 were anything but normal. Excess demand was met by snarled supply chains, labor shortages due to the pandemic, rolling factory shutdowns across the world, clogged ports, and rising shipping costs, to name a few. The phenomenon in those years is what I like to call 'inflation classic': too much money chasing too few goods. Even if we removed U.S. fiscal stimulus from the equation, there still wouldn't have been enough goods.

In 2022, the demand side of the equation is still strong, but the fiscal stimulus has largely run its course and monetary tightening is underway. What we're facing now is uniquely a supply problem (again, too few goods) that the Fed can't fully fix by ending QE, trimming its balance sheet, and/or raising the fed funds rate.

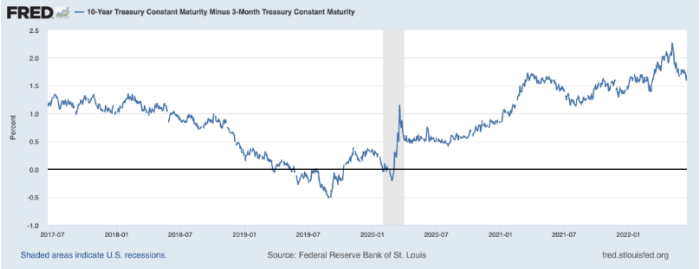
In a *New York Times* op-ed written by former Fed Chairman Ben Bernanke, he acknowledged this shortcoming when he wrote that "factors beyond the Fed's control can contribute to inflation. Supply-side forces are, indeed,

important today — not only the increases in global energy and food prices already mentioned but also pandemic-related constraints, like the disruption of global supply chains. Unfortunately, the Fed can do little about these supply-side problems."[2] Bernanke's last line there is key.

To make matters more complicated, just as the global economy was ramping back up, supply chain issues were starting to resolve, and spending was shifting from goods to services, Russia invaded Ukraine. The war clearly created major dislocations in the oil and gas markets, reducing global supply as many nations banned Russian energy imports. But the war also disrupted food supplies, fertilizer production, and further obstructed global shipping routes. Consumers around the world are feeling these inflationary effects, not just Americans.

Then the situation got worse. China implemented strict Covid-19 lockdowns across the country this spring, but most notably in the most populous and wealthiest city of Shanghai, where residents were confined to their homes for two months. Manufacturing output and spending fell, and restrictions elsewhere in the country only added to the global supply problem.

The Fed cannot do anything to change these issues. Monetary policy can soften demand indirectly, by adjusting credit markets and making access to business loans and mortgages more costly, for instance. Eventually, the Fed could raise the benchmark fed funds rate high enough that it exceeds the yield on the 10-year U.S. Treasury bond, which could essentially shut off banks' incentive to lend. That's another way of saying that too many rate hikes could invert the yield curve. But we're not there yet – the yield curve has actually steepened this year, which tells me the Fed has a way to go before choking off demand.



Source: Federal Reserve Bank of St. Louis[3]

So, what does this all mean for investors? I think for one it means we can stop fixating on the Fed's role and apparent power over inflation, which to me is much smaller and less significant than many think. The real focus should shift to the supply issue, and whether it gets better or worse from here. The outcome is key for markets.

Bottom Line for Investors

There are a few scenarios that could help global supply chains moving forward. Pressure on commodity markets could ease if oil production outside of Russia increases (which we are already seeing), shutdowns and restrictions related to Covid-19 could go away, shipping routes and backlogs could clear over time. There could also be negative surprises that hinder supply chains even further, as we have seen already in 2022 with Russia's war and China's lockdowns.

Markets tend to move on surprises when outcomes are better or worse than expected. At this point, it feels to me as though everyone is expecting the worst, or at least expecting inflation to get much worse. And that lays the groundwork for a positive surprise.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Chair Powell's Press Conference. June 15, 2022. https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20220615.pdf

[2] NY Times. June 14, 2022. https://www.nytimes.com/2022/06/14/opinion/inflation-stagflation-economy.html

[3] Fred Economic Data. June 17, 2022. https://fred.stlouisfed.org/series/T10Y3M

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- **Americans are buying less gasoline**
- **Status of the Federal gas tax holiday**
- **Median home prices hit another record**

Americans are Buying Less Gasoline

The sting of higher gas prices is starting to hit U.S. consumers. As the average national price continues to hover around $5 a gallon, consumers are showing signs of shifting behavior and filling up less. In the first week of June, the energy-data provider OPIS reported that sales at U.S. gas stations were down 8.2% compared to a year ago. The Energy Information Administration also reported that by mid-June, an estimate of gas products supplied to consumers have fallen approximately 110,000 barrels a day to about 9.1 million barrels a day. That's also down from 9.4 million barrels a day from a year ago. Consumers are rethinking road trips, utilizing carpooling and mass transit more, and this has been increasingly the case in the past couple of years, working from home more often.[1]

Is a Federal Gas Tax Holiday Coming?

President Biden decided last week to call for a 3-month suspension of federal gasoline and diesel taxes. While this move appears on the surface as though it could provide temporary relief for higher gas prices, the economic reality is likely far less significant. By the numbers, the federal tax on gas is 18.4 cents-a-gallon with 24.4 cents a gallon federal tax on diesel fuel. Even if the suspension of the gas tax was fully absorbed by consumers, it would only amount to about a 3.5% discount on price – not necessarily a game-changer. But it's also true that oil companies could benefit from the gas tax suspension, which would mean the savings are not all passed along to consumers. That would make the discount even more negligible. At the end of the day, oil and gas prices are set by supply and demand in global markets, which gives Congress and the president little power to influence prices. It may not matter anyway – the measure requires Congressional approval, and there does not appear to be enough support to pass a bill.[2]

Median Home Prices Hit Another Record

The month of May was yet another record-setting one for U.S. home prices. For the first time in the nation's history, the median price for a home topped $400,000, as the supply and demand imbalance in the marketplace continues to favor homeowners and sellers. May's median home price increase tallied at 14.8% from a year ago, a remarkable increase that has characterized the past two years. Demand has continued to push higher as millennials, who are also overwhelmingly first-time homebuyers, leave cities in favor of owning homes with space for home office setups. We do not expect this pace of price increases to last very much longer, however, as mortgage rates continue to climb and high prices discourage would-be homebuyers from entering or staying in the market. We also believe the likelihood of a 2008-like bubble in housing is low – there doesn't appear to be enough inventory in the market for a bubble. What's more, lending standards have tightened considerably since the housing crisis, and household finances are currently in good shape within a strong labor market.[3]

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[1] Wall Street Journal. June 20, 2022. https://www.wsj.com/articles/as-gasoline-prices-surge-here-are-four-ways-to-save-this-summer-11655668286?mod=markets_major_pos4

[2] Wall Street Journal. June 23, 2022. https://www.wsj.com/articles/what-is-gas-tax-biden-making-federal-gas-tax-holiday-11655934436?mod=markets_lead_pos6

[3] Wall Street Journal. June 21, 2022. https://www.wsj.com/articles/u-s-existing-home-sale-prices-hit-record-of-407-600-in-may-11655820516?mod=djem10point

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