Financial Markets This Week

Christopher S. Rupkey, CFA
Chief Economist
crupkey@fwdbonds.com

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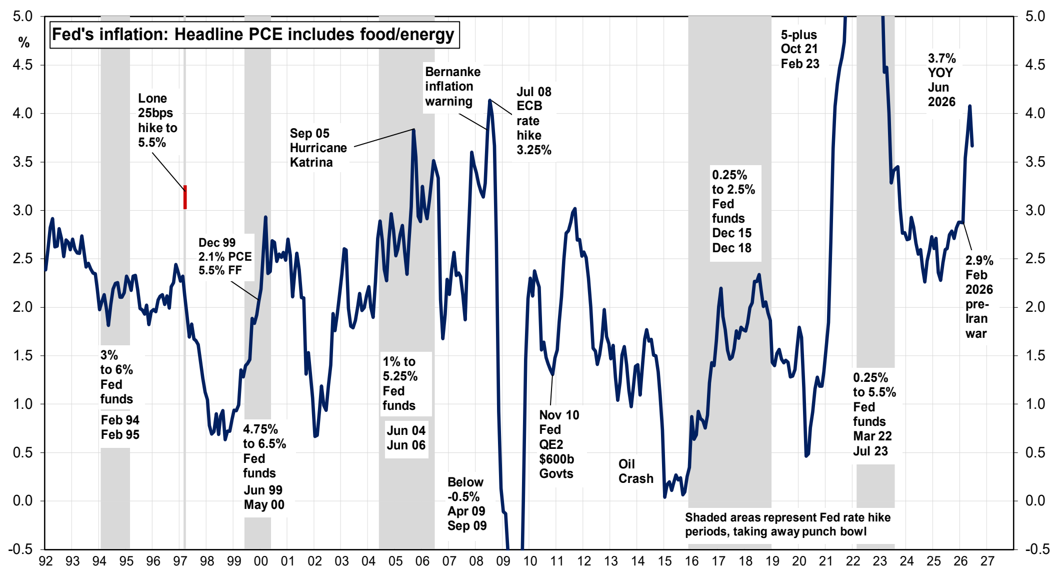
INFLATION CHOICE

A quick look back at economic history. Easy to forget headline PCE inflation that includes food and energy. The public hasn't forgotten and the affordability crisis won't be going away given PCE inflation ran above 5% from October 2021 to February 2023. This was the worst inflation since the 80s so it isn't hard to understand the public's concern. Warsh's "inflation is a choice" remark is part of the Powell Fed blew it story where they were too late to raise interest rates in 2022 in part because their forecasts locked them into doing nothing. That's been one story. We don't see how Fed forecasts tie their hands. Anyway, PCE inflation was above 5% when Powell first hiked rates in March 2022. The pace of tightening to a 5.5% Fed rate was the fastest since 1992 at least in the graph here and perhaps it helped bring PCE inflation back down below 2.5%. PCE inflation is up again and we aren't sure what Warsh has in mind to bring it down. The only tool in the tool kit is raising interest rates.



The chart here shows the Fed's reaction function differs over the cycles. The Powell Fed was late looking at the graph here, but every cycle has its own story. Inflation was fairly low during the 1994-95 and 1999-2000 tightening cycles and the rate hikes started at fairly high levels of 3.0 and 4.75 percent respectively. The economy was used to higher rates perhaps. The Fed cut interest rates to zero to stimulate the economy after the Great Recession and the pandemic downturn in 2020. Currently, the 3.75% Fed funds rate is far above zero, so the urgency to move rates higher to fight the temporary energy price shock is not the same as it was in 2022. Stay tuned. Inflation has been above the 2% target for many years, people complain. It is not clear what the Fed's course of action is to bring it down. Weaker economic demand and labor market conditions brings inflation down, but it falls for other idiosyncratic reasons where luck is involved. The plot of interest rates versus headline PCE inflation shows the Fed's tinkering with interest rates does not always bring about the desired results.

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