WILL THE FEDERAL RESERVE BE ABLE TO HELP REDUCE INFLATION?

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At its June meeting, the central bank for the U.S., the Federal Reserve (Fed) raised the "federal funds" policy rate range by 0.75%, the largest increase since 1994, and kept the door open for another 0.75% increase at its July meeting. The federal funds rate is now up to 1.50%, up from 0% since the start of the pandemic. The message from current Fed chairman Jay Powell is clear: the Fed will aggressively raise interest rates given its strong commitment to tame inflation. Although the Fed believes it can succeed in its efforts without tipping the economy into recession, its actions increase the risk of one occurring.

WHAT IS THE FEDERAL FUNDS RATE, AND WHY IS IT IMPORTANT?

The federal funds rate is a monetary policy rate that the Fed directly controls. It is the rate commercial banks charge other banks for overnight loans, but it also strongly influences the prime rate, which in turn, impacts the rates of other short-term consumer and business loans. Moreover, what the Fed *communicates* about potential future rate changes impacts the rates of longer-term loans like mortgages, car loans, and other consumer and business financing rates. Generally, the Fed reduces the federal funds target rate to try and stimulate a sluggish economy and raises rates when the economy is thriving to either prevent inflation from going too high or bring inflation down from elevated levels.

WHY IS THE FED RAISING RATES SO QUICKLY?

The Fed is raising interest rates quickly because they have been surprised by the level of inflation over the past year and by how long inflation has lasted. They have also been surprised by how "tight" the labor market has been, with the number of job vacancies currently doubling that of workers looking for employment. Because of this, the Fed is a bit late in raising interest rates. Now they are catching up.

The Fed is also concerned about declining consumer and business confidence in its ability to get inflation back down. Aside from supply and demand dynamics affecting prices, consumer and business *expectations* of future inflation can persistently drive further price increases. In other words, the Fed wants to prevent a scenario where businesses, consumers, and investors start to worry that the Fed will not be able to get inflation back down. So, by raising rates faster and more aggressively, the Fed wants to underscore the fact that they fully recognize the inflation problem and will take necessary action to ensure that inflation expectations stay down.

IS THIS GOING TO BE A REPEAT OF THE 1970S AND 1980S STAGFLATION?

Many are comparing the current situation to the stagflation period from 1973 to 1982, when inflation reached nearly 15% and stayed at elevated levels for many years amid high unemployment and stagnant economic growth. When Paul Volker came into the Fed as chairman in 1979, he had a lot of (painful) work to do after years of neglect when the Fed didn't raise interest rates sufficiently to get inflation back down. During that time, the Fed lost credibility with the market, households, and businesses. As a result, inflation *expectations* drifted up a lot, and Paul Volker had to cause a severe recession in a short period by raising the interest rates (Fed funds rate) to 20%. See **Figure 1**.

Because the Fed Waited Too Long During the Stagflation Period from 1973 to 1982, They Needed to Raise the Federal Funds Rate to Rate to 20%

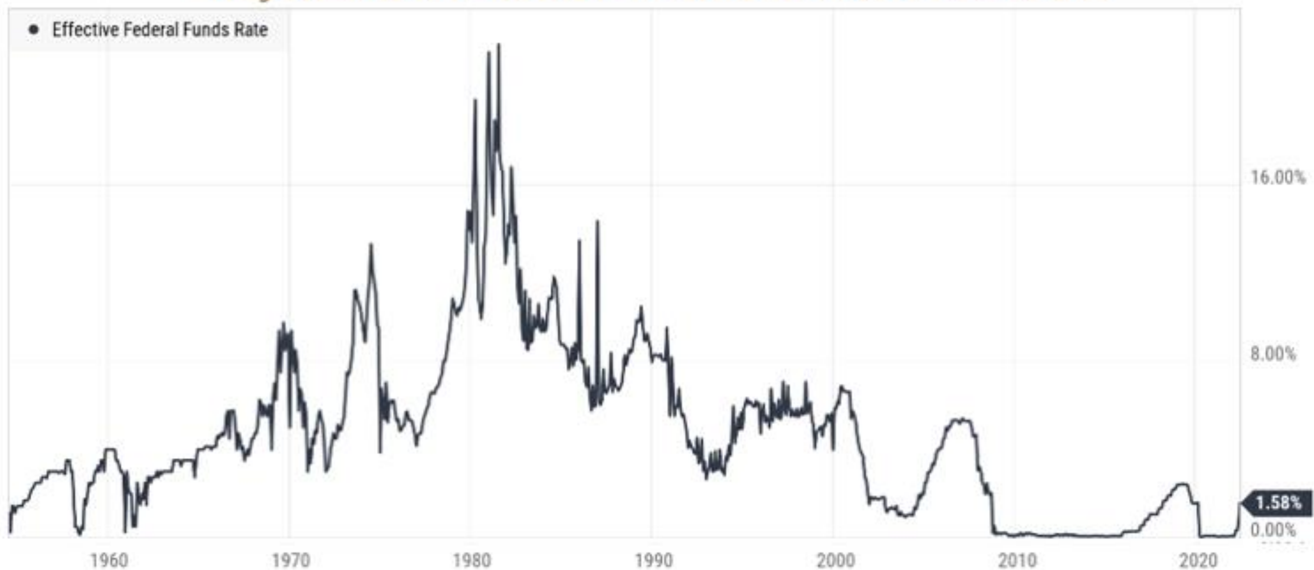

FIGURE 1. This figure shows the federal funds rate going back to the 1950s. The federal funds rate today is 1.50% and is expected to go up to around 3.5% over the next 12-to-18 months. In contrast, during the stagflation period from 1973 to 1982, when inflation reached nearly 15% and stayed at elevated levels for many years, the Fed needed to raise the federal funds rate to a peak of 20% in June 1981.

Data from 07/01/1954 to 06/30/2022. Source: Federal Reserve, YCharts

Current chairman Jay Powel doesn't want to go down that road. Instead, he wants to be more preemptive to keep inflation expectations in check. In other words, he wants to raise rates aggressively *now* to prevent having to raise them even more forcibly and to higher levels in the future. Suppose the Fed succeeds in keeping future inflation expectations down. In that case, they may be able to raise interest rates to a level (maybe somewhere between 3.5% and 4.5%) that either doesn't cause a recession or causes only a mild, short-lived one. This scenario is referred to in the financial news as a "soft landing." Currently, the Fed's forecast is pretty optimistic that this is still achievable.

IS THE FED CONCERNED THAT THE STOCK AND BOND MARKETS HAVE DECLINED SO MUCH THIS YEAR?

Chairman Powell believes that interest rate policy actually works through changes in "financial conditions" rather than through adjustments to interest rates themselves. Generally, financial conditions are the current state of financial variables that influence economic behavior and the future state of the economy. Examples of financial variables include stock and bond markets, currencies, and real estate values.

How financial markets react to interest rate adjustments is part of determining how high interest rates need to go. In other words, if the stock and bond markets are very sensitive to Fed's actions (as they clearly have been this year), then the Fed doesn't need to do as much because financial conditions have "tightened" or become more restrictive. Specifically, this is when stocks, real estate, and other asset values go down (people feel less wealthy and hence less willing to spend) and when debt costs go up (people can't buy as much as before). In contrast, if financial conditions ignore what the Fed is doing, for example: stocks and real estate continue moving up and debt costs don't rise, the Fed would need to do more and be extra aggressive to slow the economy down.

CAN THE FED ACTUALLY REDUCE INFLATION?

Multiple variables impact inflation, but the three key components are 1) the supply of goods, services, and labor; 2) the demand for goods, services, and labor; and 3) consumer and business expectations of future inflation.

The popular narrative today is that the Fed can't reduce inflation by hiking rates because they will not directly reduce the cost of food and gas or improve supply chain constraints. Although this is true, the Fed *can* still help to reduce inflation (via rate hikes) by moderating the demand for goods, services, and labor. For example, higher consumer loan rates will likely cool car and housing demand. The Fed can also alleviate inflation by demonstrating strong action and commitment to reducing it, which will reduce consumer and business expectations for future inflation. For example, if businesses expect inflation to moderate (because of firm Fed action), they'll likely not raise prices or increase wages as much.

WHAT CAN INVESTORS EXPECT GOING FORWARD?

The Fed is strongly committed to controlling inflation.

In one scenario, the Fed's current monetary tightening plan effectively slows the economy enough to bring inflation back down meaningly. Of course, there is a good chance in this scenario that Fed tightens too much, and we actually end up in an economic recession (probably a mild one). But, recession or not, this scenario will likely result in financial markets recovering at the first sign that the Fed no longer needs to become increasingly aggressive with monetary policy.

In another scenario, the Fed doesn't do enough because they're too cautious. In this scenario, inflation expectations continue to rise, and then the Fed actually needs to implement *even more* restrictive monetary policy down the road. The good news is that the Fed fully understands the risk of this potential scenario from the lessons learned in the 1970s and 1980s.

Regardless of which scenario plays out, investors are likely in for volatile markets over the next 12-to-18 months due to the uncertainty about whether the Fed's current monetary policy plan will work and, if so, when. To be clear, market volatility means the potential for both sharp declines mixed with strong recoveries. Historically, the strongest stock market increases have occurred amid bear markets.

WHAT SHOULD INVESTORS BE DOING?

Investors need to be somewhat cautious in this environment. In our view, this means taking a defensive approach by being highly diversified and investing in high-quality assets.

Within both stocks and bonds, we recommend investing broadly across sectors to avoid being overly concentrated in areas that are particularly vulnerable to rising interest rates. We also recommend tilting stock allocations toward more profitable and less expensive stocks which should continue providing strong relative performance as interest rates climb higher. Lastly, we recommend keeping bond allocations invested in high-quality, intermediate-term bonds given their much higher yields (relative to last year) and defensive characteristics against increased stock market volatility.

Investors need to stay disciplined. For those who were fully invested before this year, we highly recommend staying invested given the potential for strong (and fast) stock market increases. Expectations of what the Fed will likely do with interest rate policy over the next couple of years is mostly priced into stock and bond markets already. For those investors with excess cash (not needed for the foreseeable future), we recommend investing it on a regular basis to take advantage of currently discounted values for both stocks and bonds.

While bear marks are undoubtedly painful, enduring them is critical for better long-term returns. In environments like this, it's important for long-term investors to be diversified across high-quality assets and to stick to their strategic investment plan.

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