1919 INVESTMENT COUNSEL
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Weekly Market Insights

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The Fed at a Crossroads

Financial Markets

Investors must have felt there was nowhere to hide this past week. Financial markets in the United States and across both the Atlantic and Pacific suffered large losses. The market's reaction was inspired by comments from Federal Reserve Chairman Powell, which were interpreted as an increased concern over inflation and led many to believe the Fed would raise rates by 50 basis points rather than 25 at their next meeting. They only hinted at this, but it certainly was a change in tone. We won't hear much from the Fed, as they are now in their "quiet period" ahead of the May 3-4 meeting. Just about all major central banks around the world appear to be of the same intent. The Dow fell 1.86%, the S&P 500 fell 2.75%, and the NASDAQ fell 3.83%.

The Economy

Investors are clearly focused on the inflation and the Fed's reaction. This creates a difficult dilemma for the Fed. They want to follow their principal mandate of controlling the money supply and inflation, but they clearly want to avoid pushing the economy into a recession. Much of the economic data we see argues that the economy is continuing on a strong path and that inflation is far too high. However, there are some signs that consumer spending, which makes up about 70% of the U.S. economy, may be slowing. In a recent *Wall Street Journal* article, "Global Growth May be Slowing," three charts of Purchasing Managers Output Indexes illustrate a slowdown in the U.S., Europe, and Asia. Of course, this can be a temporary phenomenon, but if you're the most consequential central bank on the globe, it is something to think about. The other problem for the Fed is that the high U.S. inflation rate is largely due to supply imbalances rather than too much demand. If this is the case and consumer spending is about to slow, the concern is whether or not the Fed is being too aggressive. The members of the Federal Open Market Committee (FOMC) have to determine whether the primary cause of this inflation is demand or supply driven. It is our view that monetary policy is most effective in controlling demand driven inflation.

One example of a supply side contributor to inflationary pressures is the continued work stoppages in China. We have all read about the reintroduction of quarantines in China, clearly putting a further strain on supply chains. Also, transportation problems continue to plague global commerce. In 2019, it took 35 days for a shipping container to travel from Shanghai to Los Angeles. This includes all stages of transport, from empty pickup at a depot in Shanghai until eventual unloading in Los Angeles. Today, the same voyage takes 61 days. Ports with a low degree of automation and high degree of dependency on human labor, such as Long Beach and Los Angeles, have been the hardest hit. It has not been uncommon for these ports to have 70 cargo ships with more than half a million containers queuing off the coast of California. Add this to a chronic shortage of truck drivers, and you will get an idea of the problem at hand. Compounding the supply problem is the energy shortage, which is greatly due to the war in Ukraine. It seems to us that neither of these supply-driven inflationary pressures will be solved by monetary policy.

Conclusion

The Fed is in a difficult position. It is obvious to all that inflation is out of hand, and they must respond. If excess liquidity is only part of the problem and there is some question concerning the strength of economy, they must be very nimble and not attempt to solve inflation with the wrong tools.

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