19 19 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

June 13, 2022

Inflation, the Fed, and Interest Rates

Financial Markets

Financial markets continued their decline this past week. The cause continues to be fears that if inflation continues, the Fed will be forced to continue to raise interest rates, demand will fall in response, pushing the United States into a recession. Whether this actually comes to bear is an open question, but it is possible, and investors, frightened by both uncertainty and the possibility of a recession, are selling. This past week they did so with a vengeance. No sector of the S&P 500 escaped. The numbers prove the point. Energy fell 0.84%, Communication Services fell 4.13%, Consumer Staples fell 2.59%, and, worst off, Information Technology fell 6.37%. The government's report on inflation sparked the sell off, as it was higher than expected, surprising investors. We will dig into inflation and the Fed in more detail in the Economics section, but it is quite clear that investors, both retail and professional, are nervous and a bit confused.

Economics

The Federal Reserve has told anyone who will listen that its target range for inflation is 2%. Inflation is now well in excess of that. Under normal circumstances, any first year student of Money and Banking knows how to go about solving the problem—reduce money supply by raising interest rates. Unfortunately, these are not ordinary times. Manipulating money supply might not be a satisfactory response to this particular type of inflation. The inflationary problems we face are only partially caused by an overabundance of liquidity. Surely, that is a serious problem, but other problems must be dealt with as well. After the Fed began to increase money supply during the great recession, the pandemic struck, causing the Fed to reinvigorate its monetary stimulus. Unfortunately, COVID itself unleashed powerful inflationary forces by disrupting supply chains and closing transportation hubs. These supply-side problems are highly inflationary and do not respond to monetary policy. The world was already faced with highly stimulative monetary policy and a powerful supply-side inflationary force. Then, Russia invaded Ukraine. Under the best of circumstances, wars are inflationary. This one is particularly inflationary because it involves one of the world's largest suppliers of energy and one of the world's largest suppliers of wheat. Again, the Fed is faced with powerful inflationary forces over which it has very little control.

There are early signs that both the supply chain and transportation problems are slowly being overcome. If this does come to fruition, then that will relieve some inflationary pressures. Unfortunately, this does not seem to be the case with the Ukraine-Russia conflict. The cost of energy dramatically affects the global inflation rates and psyches. If the conflict were to end tomorrow, the price of energy would start to fall immediately, however, that does not seem to be in the cards.

Where does this put the Fed? Their fondest hope must be peace in Ukraine and the end of supply problems. That would allow them some breathing room. The Fed members are mindful of the pain of the great recession, so they would prefer to tighten cautiously.

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Conclusion

Inflation is the primary concern for investors, and its path over the coming months will tell us where interest rates are going, and, therefore, the markets. We do not think a quick end to the Ukrainian conflict is likely. The other supply-side problems—supply chains, commercial transportation, and labor shortages—are slowly coming around, but not fast enough to prevent another fifty basis point move by the Fed. Inflation is likely to slow a bit, but it will take time and markets are seldom patient.

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