US Macroeconomics

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Why the Fed May Have to Hike at Least 100 Basis Points

The Fed has an inflation problem. Prices are rising well above their 2% target for both the headline and core series. The lagged effects of surging energy costs, in addition to other energy-sensitive commodities, mean the economy has yet to experience the full effects of the recent supply side shock. In other words, the inflation readings are going to get worse from here, not better. However, there are several ways the Fed can deal with or react to today's thorny inflation problem.

One, oil prices could increase substantially further in the months ahead, enough to cause global demand destruction. Two, the Fed could ignore its 2% objective by adopting a higher inflation target. Three, the Fed could hike rates to slow aggregate demand, risking a recession or downturn.

The risk of the first scenario is material. Global oil inventories are being drawn down at a record pace, creating the possibility of a massive rise in energy prices, possibly to around $150 per barrel or higher. This would drain liquidity and cash from both U.S. households and corporates. Yes, the U.S. is a net energy exporter, but a 50% increase in oil prices from current levels would create enough short-term friction to dramatically slow the economy and likely induce a recession. The Fed could hold tight.

It is unlikely the Fed will change its target. Incoming Fed Chair Kevin Warsh testified about adhering to other inflation metrics, such as the trimmed mean series during his testimony, but this was political cover so as not to sound too hawkish and incur the President's wrath. Three Reserve Bank Presidents have already dissented from the FOMC's current easing bias. The Board also lost its biggest dove in Steve Miran recently, while Governor Waller, who made the most cogent case for cutting rates, has changed his tone, too. This leaves us with the third option, which is also the most consistent with historical precedent. The Fed needs to raise interest rates.

Absent Fed tightening and/or recession, there is no precedent for inflation, either headline or core, to fall enough to bring inflation back to where the Fed currently desires. Remember, too, that the longer the Fed keeps rates steady as the inflation rate rises, the more real interest rates decline. In effect, monetary policy becomes easier, thereby exacerbating the current price dynamic. What is a more positive resolution to the current situation?

War in the Middle East needs an immediate and successful resolution to quickly allow for the free flow of oil and an easing in broader supply-chain bottlenecks. Alternatively, inflation could ease if the current AI-inspired capital spending boom leads to an expansion in the economy's potential growth rate, and supply outstrips demand. This could take time to become evident, which means inflation expectations could become unmoored in the interim. Market participants should adopt a bearish bent on rates.

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