How Much Credit Does Fed Deserve for Lower Inflation?

Both the June consumer and producer price index reports were better than expected. Despite this good news, the Fed remains on track to raise interest rates by 25 basis points on July 26th to an upper range of 5.50% on the funds rate. This would be the highest reading since February 2001.

The fact that price appreciation has substantially slowed without the economy having yet gone into recession is noteworthy because it suggests that some improvement in inflation was inevitable. This is obvious from when the Fed began raising rates and when year-over-year headline and core inflation readings peaked.

The Fed began raising interest rates in March 2022, lifting the fund rate by 25 bps to 0.50% (upper range). This was followed by a 50 bp increase in May and then a 75 bp increase in June, which took fed funds to 1.75%. That same month headline inflation topped out at 9.1%. This was hardly the result of Fed actions.

Then just three months later, the core consumer price index peaked at 6.6%. In our view, changes in monetary policy do not impact measured inflation within a matter of several months. Oftentimes the effects take multiple quarters, if not years, to fully play out. The nature of the inflation process, the fact that it trends with long and variable lags, make it highly unlikely that last year’s June and September inflation peaks were the result of monetary tightening.

Historically, headline and core inflation tend to peak when the economy is either in recession or about ready to exit recession. Collapsing demand relative to supply leads to lower pricing power. Instead, much of the decline in price growth over the past year could be the result of a return to economic normalcy: the economy fully reopened, and supply-side disruptions began to dissipate. This is evident from the sharp decline in the vendor deliveries components of the manufacturing and non-manufacturing ISM surveys. Why does this matter?

It matters because the Fed has been tightening in reaction to unacceptably high inflation. But if a sizeable although exactly unknowable portion of that decline was not related to Fed policy, would it not have been more prudent to see how tightening was working through the economy and the financial system?

Once the funds rate was comfortably above zero, say between 3 to 4% as it was last fall, the Fed could have paused and surveyed the situation. The Treasury yield curve was already deeply inverted at that time, and inflation expectations had been stable. At no point since last summer have the bond market vigilantes pushed the Fed to tighten more. Policymakers had plenty of inflation-fighting credibility.

The recent Treasury price action essentially confirms this. The rally in long-end rates from last Friday which we believed was overdone, has been almost entirely the result of declining real yields. Breakeven inflation has barely budged even though the impetus for lower yields was better inflation news. This reinforces our view that the Fed that has gone too far, too fast. If past is prologue, the economy has yet to feel the full effects of Fed tightening, which means inflation could go a lot lower from here.
Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. (“SMBC Nikko”), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko’s economist(s). The views statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko, it does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.