The Fed Is Getting Too Much Credit

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Little Impact From Fed Actions On Inflation

One measure of core inflation peaked the same month that the Fed lifted interest rates off the zero bound. Since then, the annual growth in this version of core inflation is up just 2.7%. Moreover, the real fed funds rate is now significantly positive. Given the lags in monetary policy, the full effects of tightening have not been felt. If there is a recession, inflation will slow further, potentially rekindling fears of deflation.

Source: FRB, BLS, Haver, SMBC Nikko
Why Has Core Inflation Declined?

Most of the decline in inflation has been the result of a loosening in economy-wide supply bottlenecks. This is evident from the historic collapse in supplier deliveries as illustrated in the ISM manufacturing and services surveys. This improvement has had nothing to do with monetary policy but rather was the result of full economic reopening post-pandemic.

Source: Institute of Supply Management, Haver, SMBC Nikko
A Broken Fed Inflation Model

If there is any doubt the improvement in inflation was due to Fed policy, then the economy would have already seen a decline in the output gap. Instead, the current unemployment rate is above policymakers’ estimate of full employment and yet inflation within core services is rapidly slowing. The output gap is a poor predictor of inflation so the Fed should adopt a different approach.

Sources: BEA, CBO, Haver, SMBC Nikko
Massively Restrictive Borrowing Costs

The historic speed with which the fed funds rate has risen now places it above the estimated potential growth in nominal GDP. This has critical importance to the economic outlook because when the funds rate has been above nominal activity, it acts as a major break on economic activity. Put another way, when the “risk free” rate is above the economy’s long-term ability to service that interest, high borrowing costs eventually cripple business and consumer spending. This time is unlikely to be different.

Sources: FRB, Haver, SMBC Nikko
Lastly, the Index of Leading Indicators continues to decline. Over the last year, the series is down nearly 8%. Declines of this magnitude have always signaled recession but the lead times can vary. It took nearly two years from its 2006 cyclical peak before the onset of recession in early 2008.

Sources: Conference Board, BEA, Haver, SMBC Nikko
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