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Fed Policy and Inflation

Below we summarize responses to common questions surrounding Fed Policy and its effects on inflation.

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WHAT IS THE OUTLOOK FOR FED POLICY, AND WHAT DOES THAT MEAN FOR MARKETS?

In response to shaky economic data at home and abroad, the Fed has signaled that it does not plan to raise interest rates for the rest of this year. In fact, the shape of the yield curve indicates that the market expects the Fed to cut rates by at least 50 basis points in coming months. That's a big shift from where things stood half a year ago, when it looked like the Fed was on track to keep tightening. The fact that inflation has subsided quite a bit means the Fed has a lot of flexibility to respond to any weakening in economic momentum it sees. Whether rate cuts, if needed, would be sufficient to keep the economy and markets on track is another question.

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THAT'S A LOT TO UNPACK. FIRST MAYBE TELL US ABOUT INFLATION. WHAT MEASURES DOES THE FED LOOK TO?

There's more than one way to measure inflation. The most popular figure we see cited is the Consumer Price Index (CPI) that comes from the Labor Department, and the rate we typically see compares the price level for a basket of consumer goods today compared to a year ago. It's used to calculate cost of living adjustments to things like Social Security payments, and often used by economists to adjust things like wage gains for inflation. But the Fed tends to look more at the Personal Consumption Expenditures (PCE) Price Index, which is prepared by a bureau within the Commerce Department as part of their calculation of Gross Domestic Product (GDP). You usually see it as an annualized quarter-on-quarter figure, which means it's more of a current snapshot of what prices are doing, though you could calculate CPI the same way, if you wanted.

The biggest difference between the two numbers is the basket of consumer goods they measure, and the weighting they give them. PCE tends to run about a half percentage point below CPI, which has important implications for Fed policy if they're targeting a certain inflation rate, like 2%.

Another thing to keep in mind is that CPI and PCE both have headline rates, which include the entire basket, and "core" rates, which exclude food and energy. That's because energy prices, such as the oil price, can often be quite volatile, and have a big impact on food prices as well. Of course, those prices matter a lot, but it's useful to compare the two rates to understand how much of the inflation or deflation we're seeing comes from swings in oil prices, which the Fed can't easily control, and might well swing back again.

ARE THOSE THE ONLY INFLATION GAUGES THAT MATTER?

The Fed tends to be most concerned about the direction of consumer prices, but other measures can help round out the picture. The Producer Price Index (PPI) measures the prices producers are receiving for the goods they sell, either to consumers or other producers up the value chain. It tends to be more volatile than CPI and can sometimes be an early warning sign that price pressures are building, which may ultimately spill into higher consumer prices or a squeeze on profits. President Trump's latest nominee for the Fed board, Steven Moore, has argued that the Fed should look to commodity prices as an early indicator of either rising or falling prices, but not everyone agrees how instructive this really is.

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SO WHAT HAS BEEN HAPPENING LATELY?

What's happening lately is that inflation has been easing off, which has been somewhat surprising given how many years we are into this recovery, with an unemployment rate that—at least as it's officially measured—is the lowest it's been since 1969. A year ago, it looked like inflation was picking up. PPI rose to +3.4% in June 2018, and CPI hit +2.9% in July. Then the air started coming out of the tires. In the first quarter of 2019, the PCE inflation rate slowed to a crawl, just +0.4% on an annualized quarterly basis. PPI has decelerated to +1.9% in May, CPI to +1.8%. These are both below the Fed's target 2% rate of inflation. We've also seen this reflected in the ISM purchasing manager surveys of U.S. companies, where upward price pressures were a big worry about half a year ago but have cooled noticeably since.

WHY HAS INFLATION BEEN SLOWING?

Part of the reason is oil prices, which peaked in October and then fell nearly −40% by the end of the year, before stabilizing and recovering a bit. So even though wage growth has been steadily rising, that's been offset by cheaper energy. The reason oil prices have been soft—and this is the really important part—is that economic growth in China and Europe, both big oil consumers, has been slowing. And if that slowdown deepens, it's going to put downward pressure—or at least limit upward pressure—on a number of prices, globally.

SO, IS THAT WHAT'S DRIVING FED POLICY?

Inflation is an important backdrop for the Fed's decisions. If it were rising quickly, the Fed might be forced to put on the brakes, but since it's not, the Fed has a lot more room to maneuver. It's really the growth story that will influence whether the Fed feels it needs to raise rates, hold off, or even cut them. Last summer, when the U.S. economy was growing at around +4%, the Fed was expecting to raise rates 3 or 4 times in 2019. A number of economic numbers have weakened since then, and the Atlanta Fed is currently projecting +2.1% growth for Q2. The growth momentum in Asia and Europe looks even weaker, and businesses are worried about the implications of renewed trade tensions with China and other countries. This is why the Fed has backed off further rate hikes, and why the market is hoping the Fed may cut rates to revive growth.

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WHAT DOES THIS MEAN FOR MARKETS?

Interest rates have an effect both on real economic activity and market valuations. The more it costs to borrow, the more difficult it is for companies to make major investments, or for consumers to afford big purchases like homes or automobiles. In the mid-1990s, preemptive rate cuts were widely credited with reviving growth and staving off a possible recession. But the Fed funds rate was 6% then, a level more likely to actually be impinging on growth than the current 2.25–2.50%. Rate cuts today could give home and car purchases, which have been flagging, a bit of a boost. But it's less clear whether lower rates, by themselves, can entirely counter mounting business worries over trade conflicts or other disruptions.

Higher interest rates also compete with riskier equity returns, which makes stocks less attractive. Lower rates, in contrast, tend to boost share prices—as long as earnings (and expectations for future earnings) hold up. When growth started to slow in the second half of 2018, many investors grew nervous that the Fed would stick with its plan of steadily raising rates and push the U.S. economy into recession, which helped spark a sell-off in shares. Sometimes, in contrast, even bad economic news has been welcomed by the market if people thought it might cause the Fed to change its mind and ease off. But ultimately, even if the Fed does ease, it's up to the economy to perform. A more "dovish" Fed won't bolster share prices if the economy and corporate earnings stumble further. But it could give markets some breathing space to see what the future actually holds.