

# The U.S. Federal Reserve's response to tame inflation



The year 2022 is going to be a challenging time for the US Federal Bank as it tries to navigate the prevailing economic environment.

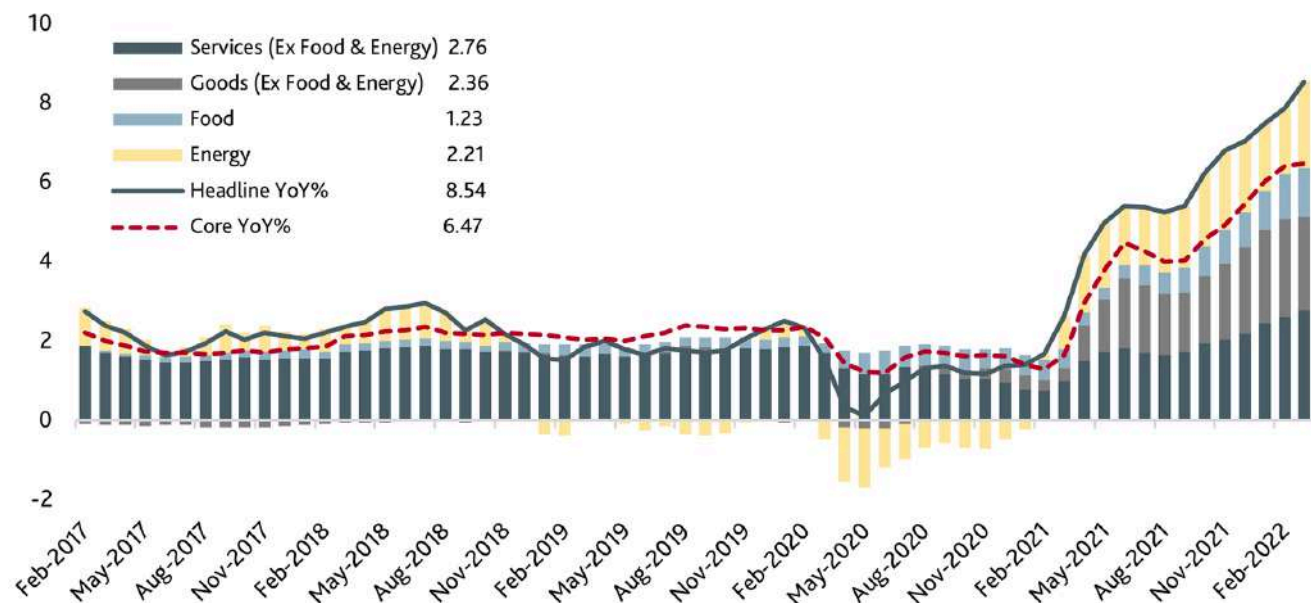
We shall be looking at the measures that the Fed has at its disposal to reign in rising inflation that has been stoked by geopolitical tensions, supply chain bottlenecks, Covid-19 pandemic, high energy, and commodity prices. The Fed is caught in a tight position whereby it must fulfil its primary mandate, which is price stability, while taking in cognisance the fragile US economic growth and tight labour market considerations.

## Has US Inflation Peaked?

US consumer prices skyrocketed 1.2% in March and 8.5% on a year-on-year basis, the biggest jump since 1981. Price growth accelerated for car rentals, hotels, and medical services. Airline fares posted the largest monthly gain on record of 10.7% in March, due to rising

energy prices as a result of higher crude prices due to geopolitical tensions in Ukraine. Accommodation costs which account for a third of the overall CPI basket, rose 0.5% for a second month. Inflation has proven not to be transitory in nature as the Fed had previously alluded too, this is event in the CPI basket component prices consistently rising and not abating. Rising consumer good prices, which were at the root of the US inflation spike over the last year, are starting to show signs of easing just as services costs accelerate.

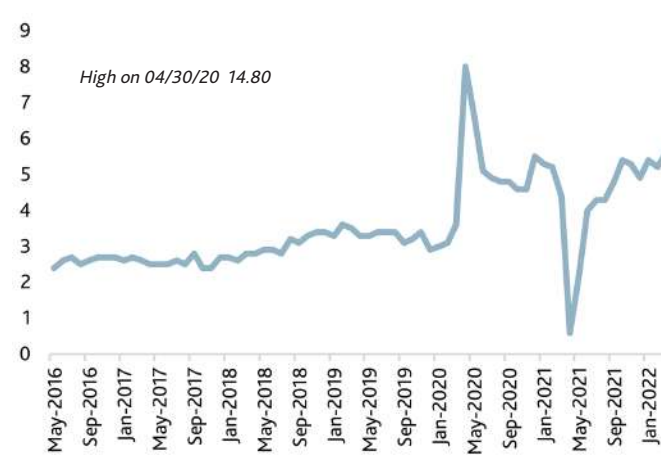
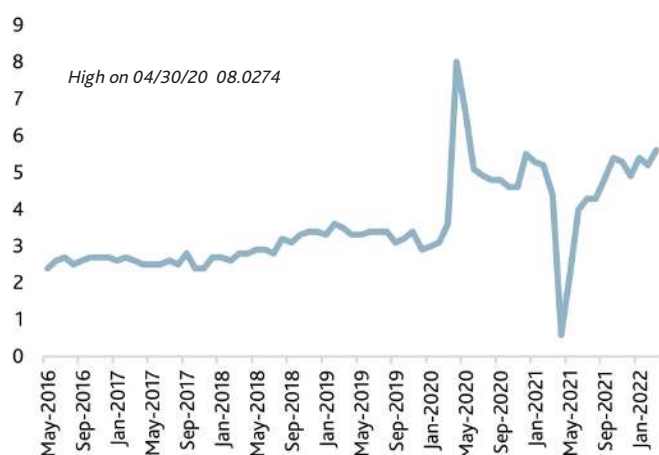
The costs of core services, which excludes energy, rose 0.6% from a month earlier, the most since October 1992 and consistent with a broader reopening of the economy from coronavirus restrictions. Personal consumption expenditures index excluding food and energy, an inflation measure followed closely by the Fed rose at an annualized 5.2% in Q421.



Source: Bloomberg (as at 30 April 2022)

Another factor that could drive services prices higher is labour costs, given the tight job market with record job openings. Rising wages will fuel risks of bigger upward pressure on prices for services such as medical care, recreation, and meals out. The shift in consumer habits from goods to services is a clear indication that consumers are under pressure due to rising inflation that has altered their spending patterns. At the start of this year, spending surged as Covid-19 cases declined. High inflation began to decrease consumers purchasing power during the Q122. The current level of inflation has eroded the wage gains that some American consumers have seen, with real wages falling 2.7%. Real wages have been declining every month for over a year now due to high inflation in the US. This underlying inflationary pressure resulting from a tight labour market could be the most crucial element keeping the Fed from raising rates quickly and back towards its long run neutral rate of 2.5%.

The US added close to half a million jobs in March and the unemployment rate fell by more than expected, highlighting a robust labour market that is likely to support aggressive Federal Reserve tightening in the coming months. The unemployment rate fell to 3.6%, near its pre-pandemic low, and the labour force participation rate ticked up. The data suggest that the labour market recovery is continuing at a robust pace as employers have better success filling a near-record number of positions. Inflation, shrinking excess household savings and solid wage growth are factors that could attract more Americans to jobs in the coming months. Covid has also become less of a factor as states broadly lift restrictions. Central bankers have repeatedly pointed to a strong labour market as one reason that the US economy can handle aggressive rate hikes that are expected to extend into 2023.



Source: Bloomberg (as at 30 April 2022)

## The economy

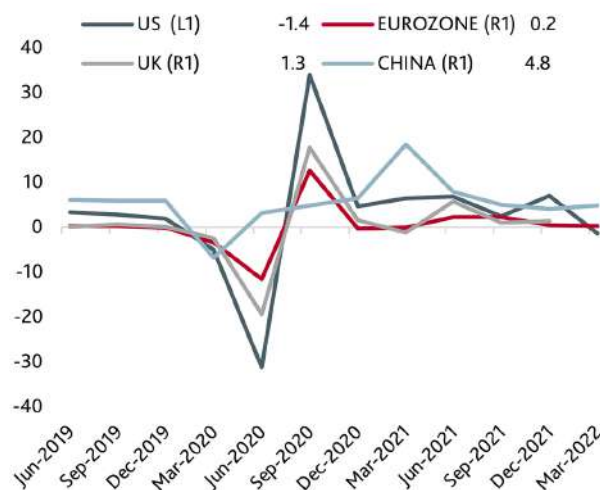
**The US economy shrank for the first time since 2020, reflecting an import surge linked to solid consumer demand which suggest growth may return soon.**

US GDP contracted at a 1.4% annualized rate in Q122 following an expansion of 6.9% in Q421. The data print caught the market off guard as estimates had predicted a 1% expansion. The contraction was due to a jump in imports and a drop in exports, coupled with a slower build-up of businesses' inventories. The GDP report showed trade subtracted 3.2 percentage points from GDP in the first quarter, reflecting a surge in imports and a drop in exports.

The US economy has recovered more quickly from than pandemic than many countries abroad, bolstering demand for foreign-made goods.

On a year-over-year basis, the US economy grew 3.6%. Trade and inventories subtracted about 4 percentage points from headline growth. Government spending also shrank, weighing negatively on growth. Personal consumption, the biggest component of US GDP, rose an annualized 2.7% in the first quarter. Services spending added 1.86 percentage points to GDP, while good purchases stagnated, reflecting changing consumer behaviour. Rising inflation and weakening fiscal support point to more moderate growth for the remainder of the year. Furthermore, higher interest rates may force companies to reduce their capital expenditures budgets.

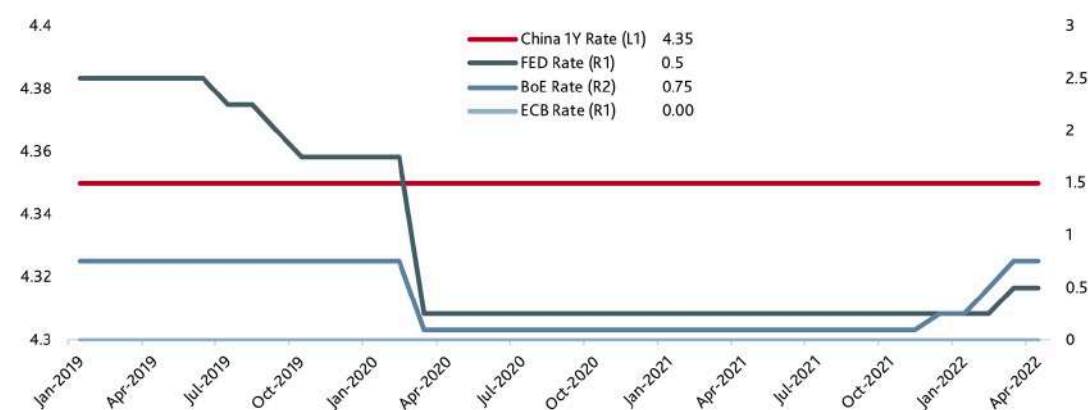
Last quarter, business investment increased an annualized 9.2%, the highest in a year and reflecting stronger equipment spending and intellectual property. Residential investment rose at a 2.1% pace, as builders began clearing backlogged housing projects. While housing demand remained strong, rising mortgage rates and record high home prices are weighing on consumer affordability and could begin weighing on housing market later in the year. The change in inventories subtracted 0.84 percentage point from the headline figure during the first quarter of 2022. Businesses will continue to replenish their inventories following the robust merchandise demand seen in 2021.



Source: Bloomberg (as at 30 April 2022)

The US economy faces other potential headwinds that include knock-on effects from the war in Ukraine. Growth prospects in Europe are deteriorating, some raw materials are in short supply and the Chinese governments severe zero Covid-19 lockdown measures are contributing to supply chain bottlenecks. The US growth is expected to rebound in the second quarter as the trade deficit and inventories headwinds become smaller.

**Risk to the view is that the continued lockdown in China will slow the Chinese economy to 3.6% way below the PBOC target of 5.5%, and supply chain constraints will have lasting and devastating effects on global growth.**



Source: Bloomberg (as at 30 April 2022)



**A robust labour market should vindicate the Fed in adopting an aggressive monetary policy stance considering the 40-year record high inflation rate of 8.5%.**

The Federal reserve is in a precarious position as economic growth as started to lose momentum in Q122, as US GDP contracted by 1.4% during the quarter. The Fed has repeatedly stated that it wants to see sustainable economic growth as well as unemployment at pre-covid levels of 3.5% before it kicks starts it tightening cycle, but cost-push inflation has forced the Federal reserve hand to adopt a hawkish stance. The other tool at its disposal is to implement quantitative tightening by rolling back on its balance sheet which has ballooned to over USD 9 trillion, with over USD 5 trillion increase in just 2 years due to the pandemic as a measure to curb rising inflation. The biggest risk that the Federal Reserve faces in its endeavour to curb rising inflation, is that growth which is already showing signs of faltering may push the US economy into a deeper recession if the Fed adopts an aggressive monetary policy normalisation.

Geopolitical tensions due to Russia's war in Ukraine will negatively affect global growth as this further exacerbates the constraints on the movement of goods and raw materials.

## Fed Reaction

The Federal reserve started its rate hike cycle in the first quarter of 2022, fuelled by the rapid rise in inflation due to spiking energy costs. The Fed reacted by hiking interest rates by 25bps from the record low levels seen during the Covid-19 pandemic. Market is of the view that the Fed will have to hike rates aggressively by a possible 50bps at the remaining four FOMC meetings in 2022 to reign in spiking inflation. Jerome Powell has reiterated the Fed's pace on rate hikes will be data dependent and will be assessed at every FOMC meeting.

In conclusion, we can clearly see that the Federal Reserve is in a precarious position as it has a dual mandate of price stability and economic growth. To achieve its mandates, it will have to act prudently due to the prevailing economic landscape. A 50bps rate hike at each meeting will have to be evaluated as to the effects it has on the US inflation path as well as the economic growth trajectory. The Chinese lockdowns due to Covid-19 pandemic and electricity crisis will result in slower global growth, as even with both the IMF and the World Bank have adjusted global growth lower to 3.6% and 3.2% respectively. The ongoing Geopolitical tensions will bring volatility in both energy and commodity prices, which will continue to fuel the global inflationary environment. Whether US inflation has peaked, that is a thorny issue that the market is grappling with as there are too many moving parts that will have a bearing on inflation expectations. The current high inflation is a global phenomenon that most economies are faced with and has forced most central banks to adopt a hawkish monetary policy stance, while halting quantitative easing. We clearly support Powell view that the path of monetary policy must be data dependent at every FOMC meeting because Fed officials will have to navigate an economic environment that is mainly driven by exogenous factors that the Federal Reserve has no control over. The market will have to adopt a wait and see approach into whether the Fed is successful in achieving its dual mandates of price stability and sustainable economic growth.