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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 is 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.

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