Highlights and Insights

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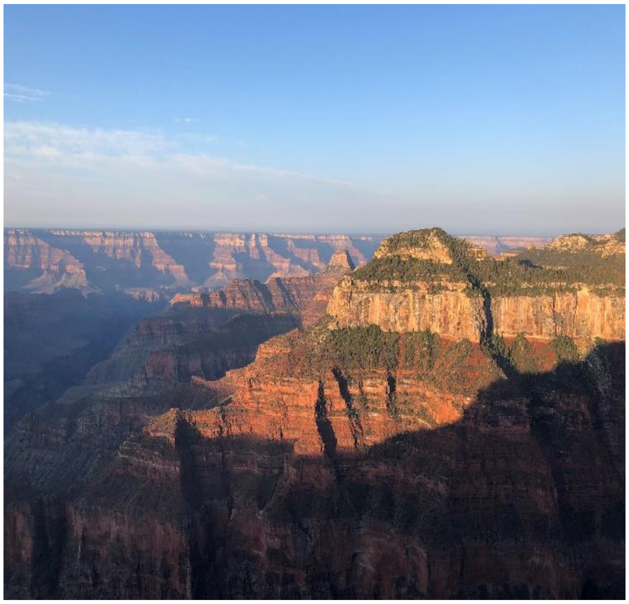

Inside This Issue

Can the Federal Reserve Resolve and the Supply Chain Slay Inflation?

In our last *Highlights and Insights,* we presented the view that the stock market had overreacted to the prospects of an imminent recession, and the sharp rebound in equity prices was a partial reflection of a less bearish estimate of the timing and severity of a downturn. There was also the sense that the Federal Reserve (the Fed) would not prolong their interest rate hikes much beyond year end. That expectation has been dashed.

As we noted in our last market letter, gains in stock prices had run into overbought conditions and were due for a pullback. The current decline in the market has brought Price to Earnings (P/E) ratios down more in line with historical norms. And, aside from the technical conditions that presaged the downturn, market sentiment was negatively impacted by stern pronouncements from Fed Chairman Jerome Powell and other Fed officials about their commitment to bring inflation down to their 2% target over time, even if it meant a “growth recession” or a “hardish” landing.

The timing of those public statements was not coincidental. The sharp rise in stock prices produced outsized capital gains over a short time period, fueling bullish market sentiment that, along with declines in bond yields, was thought to increase consumer spending that would work against Fed policy of reducing the growth rates of economic activity to contain inflation. The Fed’s inflation fighting rhetoric fueled a swift rise in bond yields, adding impetus to the stock retreat, and lengthened investor expectations of when the Fed’s rising interest rate policy would end.

The Federal Reserve is well aware that its tools to fight inflation are limited to the demand side of the economy. And the Federal government’s persistent outsized spending has hampered their efforts to rein in aggregate demand. Housing sales and construction have slowed considerably though, putting downward pressure on commodity prices, and the strong dollar has moderated export growth. But the largest contributor to the rise in inflation has been on the supply side especially energy prices, and the inflation consequences of the supply chain disruptions in pushing business costs higher. Fed policy is not designed to directly impact these factors. Nearly two-thirds of the rise in inflation over the pre-pandemic average has been due to supply factors.

But there's some help on the way. Indexes of supply chain conditions have loosened up significantly. One leading indicator from the Federal Reserve Bank of New York, which measures the costs of shipping, has declined 20% in the past month. Other components have fallen even more. Overall delivery times have declined and wait times to and from ports are down substantially. These declines are likely to be reflected in inflation during the months ahead, putting more downward pressure on headline inflation than is now expected, reviving the prospects for an economic soft landing, and restoring market confidence.