DUCENTA SQUARED
ASSET MANAGEMENT

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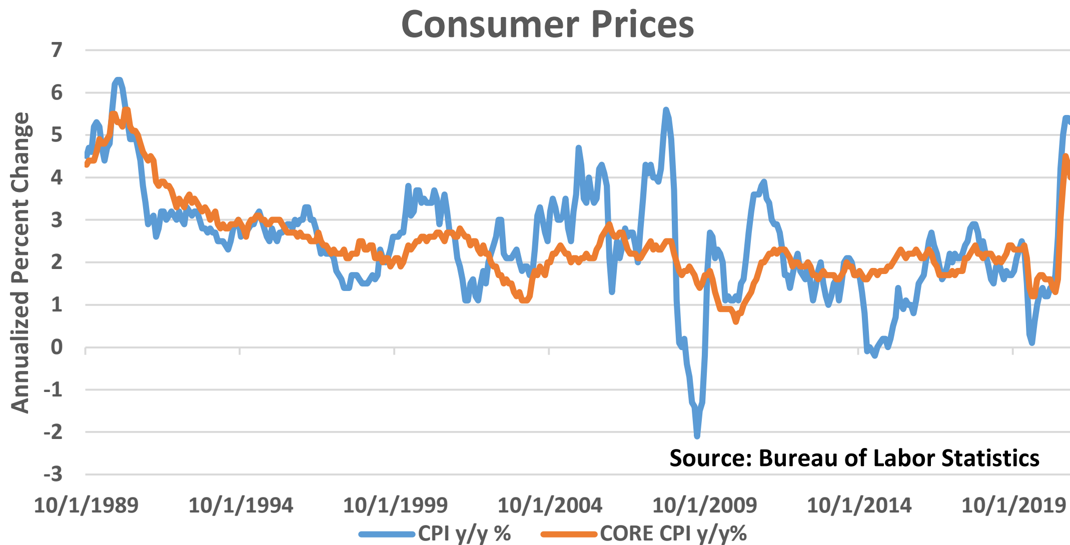
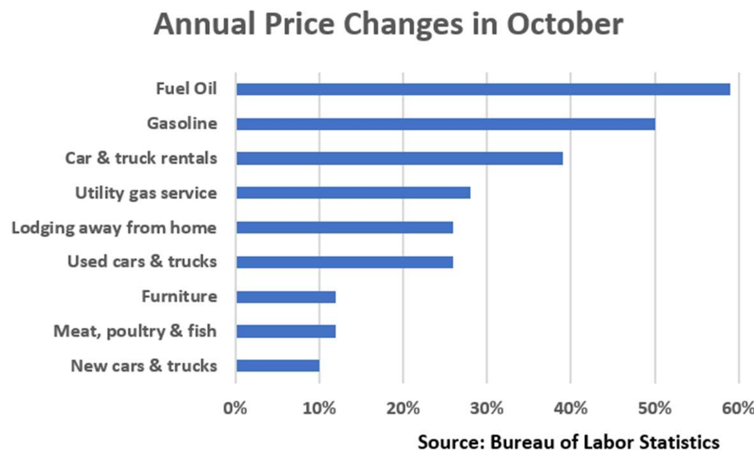
Sticker Shock

US consumers are feeling the pain of higher prices. In October, consumer prices increased at the fastest pace in three decades, as inflationary pressures spread throughout the economy. As indicated by the latest Consumer Price Index report, prices rose at an annualized pace of 6.2%, and the core index, which excludes volatile energy and food prices, increased by 4.6%, putting the Federal Reserve on the defensive.



Earlier in the year, most investors viewed price increases as transitory and limited to a narrow range of categories that were impacted by the pandemic reopening demand and supply chain bottlenecks, such as airfares, used cars, and lodging. The supply chain disruptions have lingered and may take longer to resolve while inflationary pressures have broadened across the economy. The October increase in consumer goods prices surpassed the pace of the prior three months as higher shelter rents, transportation services, and medical care services prices added to continuing increases in consumer goods prices. The chart below highlights some of the more shocking sticker price increases over the past year.



Inflation Puts the Federal Reserve Between a Rock and a Hard Place

In its November meeting, the Federal Reserve set into motion the long-anticipated plan of tapering of asset purchases, which it expects to conclude by the middle of 2022. Although the Federal Reserve seems slightly less confident regarding its inflation outlook, it nevertheless continues to believe that current inflationary pressures remain transitory.

Regarding the outlook for rate hikes, Chairman Powell adopted a somewhat dovish stance by differentiating between the asset purchase taper and the issue of interest rate policy. Specifically, Chairman Powell stated that the economy had still not met the more stringent threshold for raising rates and that the Fed was still "a ways off" from any policy changes.

Following the November meeting, the Federal Reserve finds itself in a difficult position on two fronts. Firstly, the Fed must manage the tension between its two competing policy objectives: achieving price stability and maximum sustainable employment. We believe that so long as inflationary pressures appear transitory, the Federal Reserve will be reluctant to jeopardize full employment by raising interest rates to slow the economy and combat inflation. Unfortunately, inflationary pressures continue, and the overall level of price increases reside well above the target. Additionally, relative to pre-COVID levels, labor participation currently lags by two percentage points, and payrolls trail by five million jobs. Ideally, the Fed could remain patient and use the tapering window to achieve further employment gains. If inflation persists at high levels, however, the Fed may feel pressured to raise rates before reaching the full employment goal. Notably, current positioning in federal funds futures markets price-in 2.5 rate hikes in 2022 beginning as early as July, suggesting that the Federal Reserve's patience will be tested.

Secondly, the Federal Reserve must consider the root cause for the surge in inflation and the limited policy tools at its disposal. Monetary policy works on the demand side of the economy by raising or lowering interest rates. Tighter monetary policy slows economic growth but does not address inflationary pressures if they are driven by supply shocks due to severe supply chain disruptions. On the other hand, tighter monetary policy (i.e., higher interest rates) could effectively dampen inflationary pressures if they result from a sudden and significant surge in demand brought on by the lifting of pandemic restrictions and generous government transfers.

What's the Fed to Do?

We expect inflation to advance even higher over the next several months, but moderate by the middle of next year. The combination of gradual improvements in supply chain bottlenecks, slowing economic growth, fiscal policy headwinds, and moderating demand from consumers, especially for goods, should reduce inflation back towards the Fed's 2.0% long-term average target. With economic growth slowing and inflation higher for now but lower later, we expect only one rate hike from the Federal Reserve in 2022.

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