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Fed to Meet Amid Slumping Stock Market, Out-of-Control Inflation

The central bank will likely raise interest rates this week, but by how much?

By Tim Smart   June 13, 2022

The Federal Reserve begins a two-day meeting Tuesday facing the challenge of an inflation spiral that may require it to raise interest rates to a level that markets are just beginning to take note of and do so without tanking the economy.

That task got a little harder Friday when the government reported that consumer prices rose at an annualized level of 8.6% in May, above expectations and April's 8.3% rate. The monthly increase of 1% was above forecasts and dashed hopes of those who had been saying "peak inflation" had already been reached.

Markets and experts had expected another 50 basis point hike by the Fed this month after a similar increase in May. But now there is talk the Fed may need to shock markets and the economy with a larger increase of 75 basis points.

'While tightening into a recession is no easy task, the Federal Reserve must indicate a willingness to raise interest rates by more than a half-percentage point at upcoming meetings if inflation continues to surprise to the upside," Danielle DiMartino Booth, CEO and chief strategist of Quill Intelligence, said Monday. "The Federal Reserve's slow and steady approach to tightening policy is now an outright insult to working Americans."

Friday's 880-point selloff in the Dow Jones Industrial Average suggests that the reality of entrenched inflation – and the need for bold action to stop it – is taking hold. And early Monday, Dow futures were off more than 500 points ahead of the market's open.

"The Fed knows that in the economy, it can't control supply, only demand, so the Fed will keep raising rates until demand cools sufficiently," says Gary Zimmerman, a former investment banker who is now CEO of MaxMyInterest.

"With so much pent-up demand for travel and experiences and so much dry powder sitting in bank accounts, it could take more drastic measures, or prolonged high rates, to contain inflation."

The hope was that as consumers shifted their buying patterns adopted during the coronavirus pandemic – favoring long-lived items like exercise equipment, TVs and furniture – in favor of spending on services, inflation would ease. But Friday's report showed that has not happened yet, as prices for airline tickets and even haircuts are on the rise.

"In April, the CPI report had some sprinkles of month-over-month deflation in goods such as used cars and apparel," Jason Pride, chief investment officer of private wealth at Glenmede, wrote on Friday.

"However, the inflation observed in May's report is more broad-based, as all of the major sub-categories registered monthly gains in price. Even used cars and trucks, which had been on a three-month trend of outright deflation picked back up with a 1.8% rise in prices for the month."

"Today's report should extinguish any pretense that a 'pause' in rate hikes will likely be appropriate by the end of summer, as the Fed is clearly still behind the eight ball on bringing inflation under control," Pride added.

Compounding the Fed's job is that much of the inflation is being driven by events out of its control, like the war in Ukraine that has upended energy supplies and pricing, with the average nationwide price of a gallon of gas hitting the $5 mark on Saturday. Food prices are also a major factor in the inflation spike, rising 12% in the past 12 months. That is also tied to the war, as both Russia and Ukraine are major suppliers of agricultural and related products.

"What will be most interesting to watch in the weeks ahead is less how the Fed responds," says **Bernard Baumohl, global chief economist at the Economic Outlook Group.**

"We already know they will hike rates next week by another 50 bps, or perhaps even 75 bps in light of this latest CPI report, to be followed by a similar increase in July. No real surprise here,"he says.

"What is worth monitoring now is to what extent households will change their behavior," **Baumohl** adds. "We have already seen some demand destruction both in purchases of discretionary items and even of gasoline."

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