Fed’s Powell in Hot Seat as He Stares Down Inflation in a Pivotal Week for the Economy and Markets

The central bank chairman knows his legacy is tied to whether he can break the fever of inflation.

By Tim Smart
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If there is another person in Washington feeling the heat for the current inflation nightmare as much as Joe Biden, it is Jerome Powel

The chairman of the Federal Reserve joined in the chorus of administration officials and much of the economics world throughout 2021 saying inflation was “transitory” before switching gears and admitting the obvious – that it had lost control of events.

But the pivot away from bolstering the labor market to fighting inflation appears to have come too late, despite the unusual 75 basis point hike in interest rates Fed officials approved in June. Now, the Fed is playing catch-up following the recent June report on consumer prices and faces the possibility it will only be able to break the back of inflation by throwing the economy into a recession.

“That report was a shocker,” says Gene Goldman. chief investment officer at Cetera Investment Management, of the June reading that inflation had reached a 9.1% annual rate. “Powell’s post-meeting conference was all over the place. The takeaway we got is he is willing to put the economy in recession to tame inflation.”

Economic growth declined by 1.6% in the first quarter and is skating close to a negative number for the second quarter, due to be released on Thursday. But before that, the Fed’s monetary policymaking committee will meet Tuesday and Wednesday amid expectations of another 75-basis-point hike.

The meeting is pivotal, as the economy is now showing distinct signs of a slowdown. Last week’s housing numbers confirmed that this once red-sector of the economy is now softening, with new construction down along with existing

home sales. Unemployment claims are rising, consumer sentiment has soured and spending on large-ticket items has slowed.

Talk of a recession is only getting louder as economists fear the Fed cannot win the battle against runaway prices without a defeat for the overall economy. The Blue Chip survey of economists released recently forecasts inflation for all of 2022 to be 7.8% – up from 7.4% just a month ago.

Asked whether a recession is in the cards, the panel "put the probabilities of recession this year at 36% and 49% next year; these were up from last month's survey when they were 26% and 39% for this year and next, respectively." Much of the discussion heading into the week has been about what Powell signals for the Fed beyond this week's debate over whether it hikes rates by 75 basis points or higher.

"In either case, the Fed will be continuing on its very aggressive path of rate hikes to fight off the inflation, which has been so devastating to American families," says Dan North, senior economist for North America at Allianz Trade. "But in doing so, the Fed is really slamming the brakes hard on the economy, raising the risk of recession."

North points out that higher mortgage rates are already hitting the housing market. "Applications for purchase mortgages fell 7% in the past week and are 19% lower year over year."

Powell is intent on using the Fed's main tool of higher interest rates to break rising inflation, but the type of pricing pressures the economy faces today are distinct from prior cycles when economic downturns were marked by weak economic demand or financial crisis.

"The Fed can ratchet up rates to the point where it sucks all the oxygen out of the economy and you still will not make much of a dent in bringing inflation close to the Fed's 2% target," **Bernard Baumohl, chief global economist for The Economic Outlook Group**, wrote recently. "It's like firefighters pouring water on a building when the actual blaze is happening across town."

When the coronavirus struck America in early 2020, the Fed did what central banks always do when faced with a potential economic crisis. It poured money into the financial system by slashing interest rates to near zero and buying up Treasury and mortgage-backed securities. That is viewed as the preferred medicine to keep financial markets liquid and credit flowing. At the same time, Congress approved three rounds of fiscal stimulus.

But while the economy crashed following the declaration of the coronavirus in March 2020, it quickly recovered and millions of people who had been laid off, furloughed or otherwise removed from the labor force came back to work. That occurred both in person and remotely.

As people began earning paychecks again, stimulus checks and other assistance from the government kicked in. The result was households suddenly found themselves flush with cash but with nowhere to spend it, as restaurants, travel destinations and other places were closed or operating at less than full capacity.

The money ended up being spent on houses, patio furniture, exercise equipment and other goods. Meanwhile, people were slow to return to work physically, companies struggled to find workers amid a tight supply, and wages began rising at a rate not seen in decades.

Add in global supply chain disruptions that made it hard to find semiconductors and crucial commodities and the fire was lit for a rapid increase in prices worldwide.

In hindsight, it is easy to see that inflation was beginning to move sharply upward by the fall of 2021 but the Fed did not really begin to correct its easy money policy until the spring of this year.

The final straw: Russia's invasion of Ukraine in February that led to a rapid increase in energy prices. Gasoline prices in the U.S. topped $5 a gallon, though they have recently declined for a month.

The June consumer price index was a shocker. Inflation rose at an annual rate of 9.1%, surpassing estimates, and the fastest pace since late 1981. While White House officials tried to soften the blow by pointing out the data is backward looking and reflects energy costs that have since fallen quite a bit, the optics and politics of inflation perhaps heading toward 10% was hard to avoid.

"The general price level is now almost 10% higher than a year ago," said Peter C. Earle, research fellow at the American Institute for Economic Research. "The word 'transitory' is going to haunt the Fed for decades."

As much as inflation itself, the Fed needs to see the psychology around higher prices changing so expectations of inflation do not drive it higher.

A survey from the American Staffing Association and the Harris Poll released last week found nearly 6 in 10 workers worry their paychecks are not enough to inflation. Some 27% said they plan to look for another job to supplement their income, while 20% plan to seek a raise.

Driving much of this is energy, reflected in the June CPI, showing that gasoline prices rose 11.2% for the month and were up nearly 60% year over year. But the broader effect can be seen in the price of electricity, which soared 1.7% for the month and 13.7% for the year.

But it is deeper and more pervasive than that. Even the costs of haircuts and a visit to the dentist are rising at rates well above the norm.

Many of these hits are outside the ability of the Fed, or anyone in Washington, to fix. The higher costs of energy that filter into many corners of the economy, in particular, have driven the inflation rate up by 2 to 3 percentage points alone.

It is also a different economy than that of the 1970s or the 1980s, or for that matter, the 2000s. Prior to 1978, for example, if an airline wanted to change an airfare, it had to file an application. Now, fares change online in real time.

Globalization, deregulation and technology have radically increased the pace at which the economy responds to changes in consumer behavior, both on the upside and the downside. Yet the government and the Fed's tools are blunt and operate with a time lag.

While Powell says the Fed is in control of the inflation battle, "month to month passes and we don't see any control," says Ellen Gaske, G10 Economist at PGIM Fixed Income. "People want to see an instant reaction but there's a time lag."

And with globalization, "the U.S. has to share the stage for resources with a broader geographic reach of economic activity.

There are signs that some of the inflation is receding. Housing prices, while still climbing, are leveling off and sales have slowed. Supply chains are coming unclogged. Wages, while rising, are doing so at a slower rate. And economic demand has fallen.

"We do think we are past peak inflation," says Cetera's Goldman, noting that his optimism centers on the markets where "there's been a lot of capitulation" and second-quarter corporate earnings which are holding up amid the economic strain. Still, his firm's Fed-O-Meter still is planted firmly in the higher chance of an aggressive Fed policy going forward.

But it is a slow process and inflation can often continue rising on a year to year basis even as some prices fall or slow down.

"This business cycle is dizzying," says Greg Daco, EY-Parthenon chief economist. "Real GDP is likely to have contracted in Q1 and Q2, but job growth remains robust. Inflation is leading to record low consumer confidence, but consumers are still spending. Markets are pricing a 75 basis point to 100 point Fed rate hike at the end of July, while simultaneously pricing two three 25 basis point rate cuts in 2023."

History suggests it often takes more to tame inflation than economists expect. In the mid-to-late 1970s and into the early 1980s, efforts to bring inflation under control were not successful until former Fed Chairman Paul Volcker raised interest rates to double-digit levels and the economy suffered a brutal recession.

Few remember that Volcker was Carter's second Fed Chairman. G. William Miller, a former business executive, led the central bank as inflation began to gain a foothold, resisting calls to raise interest rates aggressively until it was too late.

He was moved to treasury secretary in a Cabinet shakeup ahead of Carter's unsuccessful reelection campaign.

Volcker, a former head of the New York Federal Reserve Bank, who at 6 feet, 7 inches tall was literally a towering figure, forced interest rates to 20%. A brutal recession ensued and the White House had a new occupant in Ronald Reagan.

Volcker's name has been resurfaced in Washington during the recent upsurge in inflation. Powell – and Biden – may not want to see history repeat itself.

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