

Can the Fed Tame Inflation?

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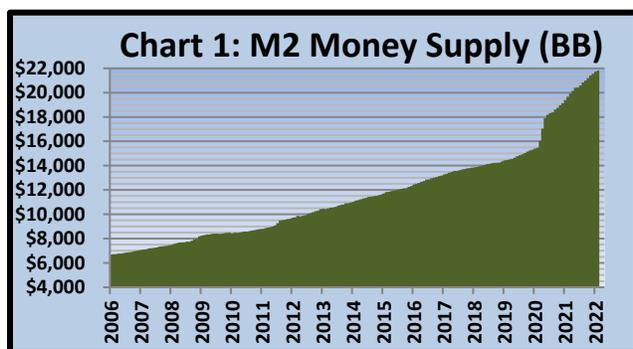
It's often said that economists are a wishy-washy breed, always qualifying their opinions with "on the other hand" hedges. That's something of a canard, at least when it comes to the more famous practitioners of this black art: Larry Summers, Milton Friedman, James Grant, and others all have (or had) strong opinions, and no inconvenient facts could dislodge them of those ideas.

Consider inflation, for example. Friedman, the Nobel laureate monetarist, maintained that it "is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." To Friedman, money supply is the only thing that matters. In contrast, Grant sees gold as the only inflation vaccine: The Fed is "devoted to raising economic growth and employment through the dubious means of suppressing interest rates and printing money. The nice thing about gold is that you can't print it."

And then there's Professor Summers, who has been just as steadfast in his own view of inflation, namely that excessive government spending is the primary culprit. He particularly excoriated CARES Act and American Rescue Plan stimulus checks, which he argues "crowded out political space for desirable long-term investments in the Build Back Better plan."¹

Federal Reserve chair Jerome Powell is certainly familiar with all three of these esteemed economists. So as Mr. Powell mulls the Fed's options for taming inflation, it might be helpful to know whether high prices are due to money supply (Friedman), absence of a gold standard (Grant), or fiscal imprudence (Summers). Or maybe it's something else entirely. Getting the *causes* of inflation right can help the Fed hit upon the right *solution*.

Far be it for me to argue with luminaries like these – I just look at the data. Perhaps a few graphs might give the Fed a sense of how to proceed. Taking on Milton Friedman first, Chart 1 shows

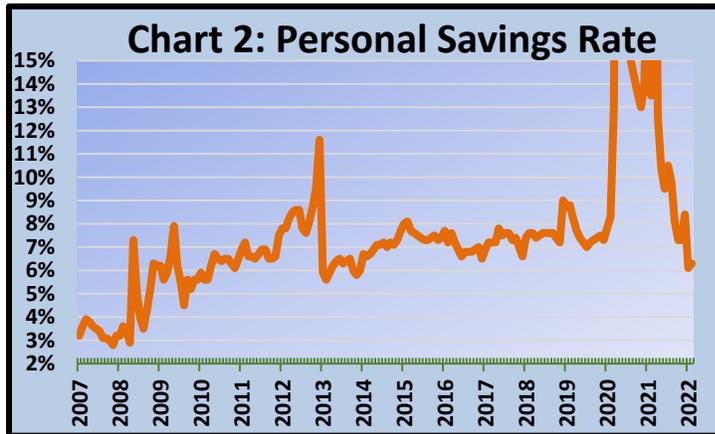


Source: Federal Reserve

that the money supply had been growing at 2% annually until the onset of the pandemic, in line with CPI over the same period. The Fed responded to the economic lockdown with a vast increase in the money supply to ensure liquidity, and it worked without causing inflation. But after the lockdowns eased, the Fed didn't let up, instead choosing to continue pumping liquidity.

¹ Howlin' Wolf foretold this theory more than six decades ago when he imagined himself complaining to his congressman: *I asked you for water / Oh, you brought me gasoline*. Enough stimulus can be lifesaving; too much might be incendiary.

Chart 1 certainly appears to support Friedman’s view (albeit with an unexplained time lag of about 18 months between the increase in money supply and the initial acceleration of inflation), but it fails to account for where the money went. Friedman assumed that consumers would automatically spend their dollars, as opposed to saving or investing them. Chart 2 tests this assumption. Immediately after the Fed’s massive jolt to the money supply in April 2020, the



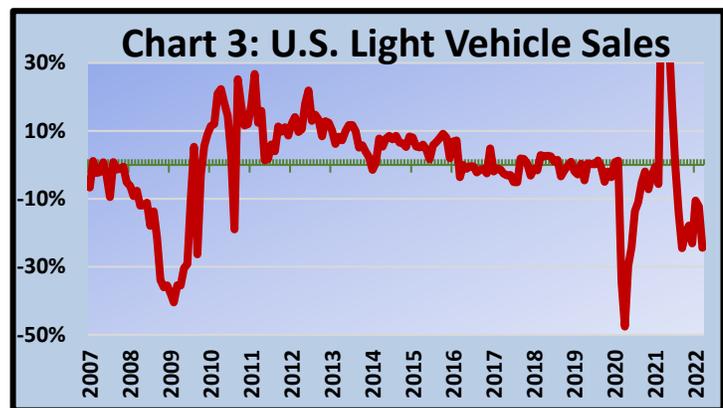
Source: Federal Reserve

savings rate soared literally off the chart to an unprecedented 33% of disposable income. Contrary to Friedman’s assumption, we didn’t spend the stimulus payments – we stuffed them into our bank accounts.

Over time, as lockdowns eased and as layoffs turned into rehires, the savings rate has drifted back to more normal levels. We kept those original stimulus payments, and then we reverted to our previous savings habits as our paydays resumed. The savings rate today is

well within normal bounds, indicating that we haven’t been irresponsibly blowing through the stimulus payments on a government-sponsored spending jag. Inflation can’t be attributed directly to stimulus payments.²

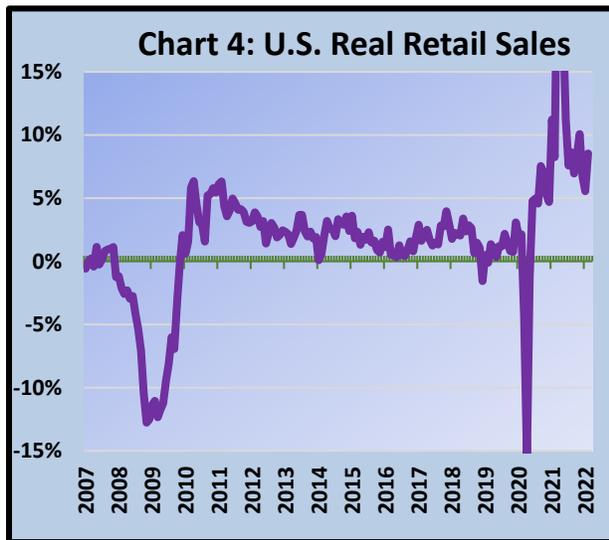
The problem with the personal savings rate shown in Chart 2 is that it is a notoriously difficult number to quantify accurately, because it is derived from other government statistics rather than measured directly. Observational spending data tell a more complicated story. Chart 3 shows the annual change in unit sales of passenger cars and light trucks, which have experienced among the highest rates of inflation in our economy. Demand collapsed during the Covid lockdown, then recovered when restrictions eased; many consumers concluded that they would rather drive personal vehicles than rely on mass transit. But a year later, unit volumes have once again turned sharply downward. Demand appears to be extremely sensitive to price, and post-pandemic consumers are not willing to pay higher prices for their cars. This observation is in direct contradiction to Summers’s argument: We have the money in our pockets, but we aren’t spending wildly.



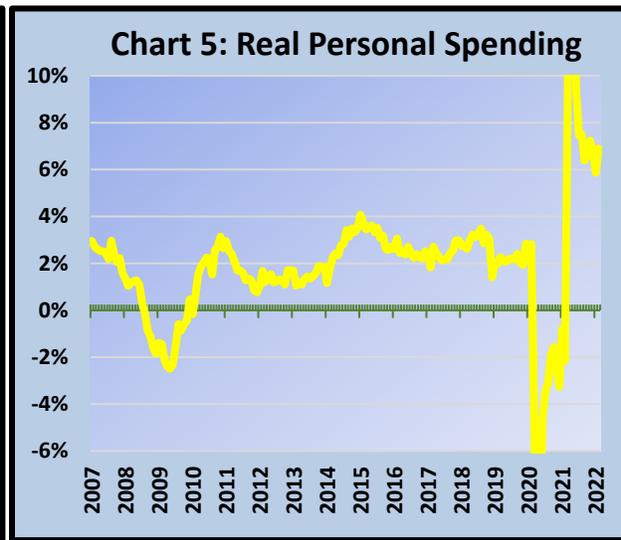
Source: Commerce Department

² The Friedman hypothesis also fails to explain why Europe and many other markets are also experiencing high inflation numbers, but without seeing either large increases in the money supply or in fiscal spending. If they were correct, inflation in other markets would be much lower than it is in the U.S. today.

Broader views of consumer spending don't paint nearly so a clear picture. Chart 4, for example, shows overall U.S. retail sales adjusted for inflation. The big picture looks roughly like Chart 3: A bust, a quick boom, and then settling back; but overall sales growth is still running hot at about 8.5%, compared with a 3% average during the decade following the 2009 recession. Similarly, personal consumption expenditures data, shown in Chart 5, suggest that consumers have begun to normalize spending at higher levels than they did through the 2010s, even after adjusting for inflation. Perhaps we are beginning to feel itchy about the money in our bank accounts after all.



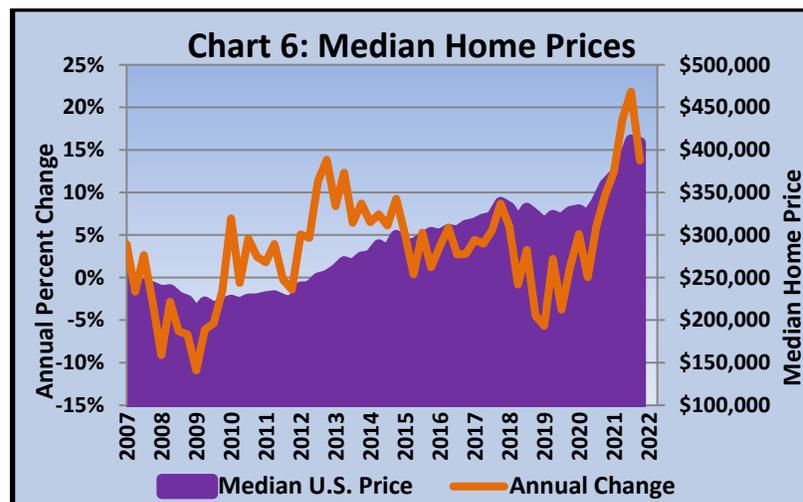
Source: Census Bureau



Source: Commerce Department

Based on these pictures, it would be difficult to accept either the Friedman or Summers hypotheses as the primary causes of our current inflationary episode, but it's also fair to acknowledge that each theory does have some merit. They still leave unanswered an important question, namely identifying what happened to the money supply and to the stimulus payments if they didn't entirely go into the consumer economy.

Chart 6 shows one destination: the housing market. As consumers fled dense urban areas during the pandemic, they bought new homes in record numbers. A strong stock market and ultra-low interest rates helped them bid prices to unprecedented levels. Were it not for a persistent shortage of about 2.5 million homes in the U.S., an impartial observer might even wonder whether a housing bubble was forming.



Source: Census Bureau

Here it's important to separate two distinct attributes of home ownership: real estate and residency. When you buy a home, you are acquiring both a property and the right to reside on that property. Only the latter is considered "consumption" and therefore included in various government inflation indices. Using rental market data and stock market indexes as proxies for the "residency" and "real estate asset" constituents of home prices, it's reasonable to conclude that the residency (or "owner-equivalent rent") part of home prices has increased only modestly, while the real estate asset price has risen sharply. The double-digit price increases shown in Chart 6, in other words, stem from the *asset value* and not from the *rent*. Home prices have been rising at double-digit rates, but they haven't been contributing to the inflation rate any more than they have in the past.

Chart 6 does tell us, however, that much of the increase in personal savings went into the *asset value* part of home prices. When consumers received windfall payments from the government (and implicit gifts such as the continuing suspension of student loan payments), the money didn't entirely stay in their checking and savings accounts. Instead, a large portion filtered into the stock market and the residential real estate market. Friedman and Summers have inadvertently explained *asset price inflation* fairly well, while missing the mark on *consumer price* inflation.

Demand-driven vs. Supply-driven inflation

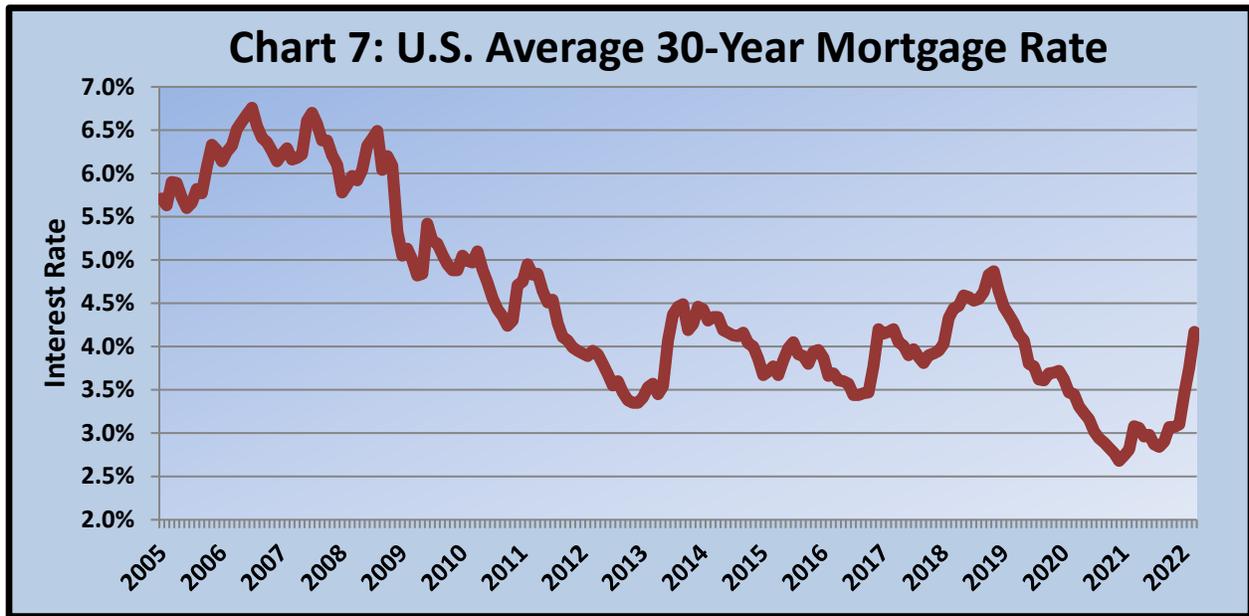
All of which brings us back to the Federal Reserve and its campaign to curb inflation by raising interest rates.³ The orthodox theory is that higher interest rates will cause consumers and businesses to borrow less money, chilling the euphoria presumably caused by too much money supply or too much government stimulus. (Remember "irrational exuberance"?) In short, higher interest rates attack inflation by reducing demand.

Yet the data suggest that demand isn't really the problem today; yes, it's probably a bit overheated in some areas, but not by enough to explain an 8% inflation rate. Instead, today's inflation stems mostly from the *supply* side of the economy, specifically from issues that mostly predate Covid and remain prevalent today: import tariffs, disrupted supply chains, labor shortages, and (much more recently) fossil fuel and food shortages caused by the war in Ukraine.

The Fed can't fight supply-driven inflation; it doesn't have the tools or the authority. That's why we have been cautioning clients to expect inflation to remain higher, and for longer, than many of our counterparts at other firms have been suggesting. But the Fed's hawkish turn can still affect asset prices, and indeed it already has. The Treasury bond market just completed its worst quarter in 40 years, almost entirely because traders began to incorporate higher interest rate projections into their forecasts. (Higher interest rates usually correlate with higher bond yields, which in turn force bond prices downward.) The drop in stock prices during the March quarter was also largely attributable to the Fed's new attitude.

³ You can forget about James Grant's theory of gold, by the way. Since inflation started to accelerate in July 2020, gold has depreciated by 2%, in contrast to the 40% jump in the money supply and a 9.7% increase in the consumer price index over the same period. Gold turns out to be neither an inflation hedge nor a good substitute for "paper" or "fiat" money.

Perhaps more significantly, higher interest rates will also affect the real estate asset values of home prices (i.e., the part of home’s purchase price that is not associated with the rental cost of living there). Chart 7 shows that average 15-year and 30-year mortgage rates plunged during the 2008 financial crisis when the Fed cut overnight interest rates to zero; then they rose modestly during the Fed’s 2018 tightening cycle, before dropping again to all-time lows after the Fed’s pandemic-related adrenaline shots to the economy.



Source: Freddie Mac

Now that the Fed is raising overnight rates again, the mortgage market is once again reeling: The interest rate on a standard 30-year fixed mortgage has jumped from 3.1% rate last December to 5.1% today. That two-percentage-point difference may not seem like much, but it has a profound impact on monthly payments. According to Google’s embedded mortgage calculator, a standard \$500,000 mortgage at 3.1% last December would have cost about \$2,135 per month excluding fees and taxes. The same house today might be priced about 5% higher; a \$525,000 mortgage at 5.1% would run \$2,850 per month. Taking the increase in purchase price and the higher interest rate together the true cost to purchase this hypothetical property jumped more than 33% in just four months, and the Fed has barely begun to act!

The biggest impact of the Fed’s interest rate campaign isn’t likely to be on consumer prices, but on home prices. By pushing mortgage rates higher at a time when housing is still in short supply, the Fed will effectively be chilling the market, locking more people into their current residential situations and curtailing the enormous “multiplier effect” that home sales can have on the economy. If so, then the risk of a recession in the next year or two is considerably greater than most economists expect.⁴

⁴ It’s worth noting here that the University of Michigan’s Consumer Sentiment index is plumbing lows not seen since the depth of the 2008 recession. Consumers sense that the economy might well be headed toward higher inflation and a possible recession, and they are worried. Maybe consumers are smarter than economists.

We might be headed for a painful combination of sustained higher inflation and impending recession in the coming years, unless the Fed deftly engineers a “soft landing” by quelling inflation without dampening consumer demand. That will be quite an accomplishment, but it’s not implausible or even improbable. As we continue to evolve to a post-pandemic normal; as supply chains unkink themselves; as workers continue to return to the labor force; and as the war in Ukraine eventually reaches resolution – many of these supply-related causes of inflation will dissipate. As that occurs, steady consumer demand will be met by better supply.

We can’t predict whether or when these macro geopolitical and real-world events will occur – and neither can Milton Friedman’s latter-day disciples, Larry Summers, James Grant, or any other brilliant and opinionated economist – but these are the factors that will have as much to do with taming inflation as anything the Federal Reserve can do. Rather than relying on this theory or that one, the Fed might do well just to watch the data and act on actual consumer and business behavior.

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