Quick take: Will June’s inflation numbers change Fed policy?

July 22, 2022

Three questions for investors to consider when thinking about the Fed’s approach to inflation.

Even as the Federal Reserve (Fed) has been undertaking [aggressive monetary policy](#) designed to clamp down on rising prices, inflation continued to accelerate — increasing 9.1% in June. How significant will this be for the Fed’s policy moving forward?

Here are three questions for investors to consider:

Does recent inflation numbers mean the Fed’s policies aren’t working?

No. It takes time for higher interest rates to work their way through the system to knock down demand and put downward pressure on prices. The question is not whether — but how quickly — inflation will drop back toward 2%. Early indicators suggest the policies are effective. Wage growth, which is an important marker for the Fed, has been slowing. Financial conditions have tightened considerably, so it’s become more difficult and expensive for companies to do business. With real yield on the 10-year Treasury up 175 bps and mortgage rates doubling since the beginning of the year, everyone is feeling the pinch.

How is the Fed defining success?

The Fed has been clear about its definition of success. It’s looking for “compelling evidence that inflation is moving down, consistent with inflation returning to 2%,” and it will continue the current hiking cycle until it does. In the process, we’ll likely see the broader economy slow down and an increase in unemployment. Success for the Fed may not feel so great in economic terms, but the central bank knows that we must pay this price to root out inflation.

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Is the level of inflation the most important number to follow?

While the absolute level of inflation is important to the central bank, it's laser focused on inflation expectations — the direction consumers think inflation will go from here. Higher inflation expectations matter to the Fed because they feed into consumer behaviors today. If employees expect higher prices, they will demand higher paychecks to keep up with the anticipated increased cost of many goods and services. Rising wages could drive companies to increase prices further, running the risk of creating a vicious cycle of wages and prices (referred to as a wage-price spiral). If inflation expectations become unanchored in this way, it would severely erode the Fed's credibility and could negatively impact markets. With its reputation on the line, we think that the Fed will do whatever is needed to keep inflation expectations from becoming unmoored.

Markets will be observing the Fed as it struggles with the question of how high it will need to increase interest rates (also called "terminal rate") to begin seeing a reversal in inflation momentum. It's an exceptionally difficult question to answer because its policies work with a lag. Because it doesn't have the luxury of time, and the cost of getting inflation wrong is too high. This will likely mean the Fed will move more quickly and aggressively. For investors, this could mean continued uncertainty and higher volatility going forward.

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