Opinion **Markets Insight**

You are what your real fed funds rate says you are

Timid US central bank is still very far from hawkish with policy benchmark deep in negative territory after taking into account inflation

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Despite history, the Federal Reserve believes it can engineer a so-called 'soft landing' © AFP via Getty Images

Richard Bernstein YESTERDAY

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Former NFL coach Bill Parcells once famously said, "You are what your record says you are." A team's coach might try to rationalise a losing record by highlighting good planning, unfortunate injuries, or players' small miscues but the stark reality is a team with a losing record is a poor one.

The Federal Reserve claims to be fighting inflation, but before one proclaims the central bank "hawkish", it seems appropriate to paraphrase Parcells: you are what your real fed funds rate says you are.

The real fed funds rate (ie the difference between the target rate for the central bank and inflation) has historically been a reliable gauge of the monetary policy. When the real fed funds rate is positive, interest rates are high enough to slow nominal growth. But when the real fed funds rate is negative, it suggests the Fed is trying to stoke the economy.

Every US recession in the past 50 years has been preceded by a positive real fed funds rate. And the Fed correctly kept the real funds rate negative during most of the period after the financial crisis because the fall-off in bank lending made deflation a bigger risk than inflation.

Despite the fact that inflation is at a 40-year high by virtually any measure, the real fed funds rate is now negative to a degree that is far beyond historic averages. Measured using the consumer price index, the real fed funds rate is negative 7.5 per cent versus the 50-year average of 1 per cent. The real funds rate was more than 10 per cent at the peak of the 1980s inflation-fighting Volcker regime.

The US and global economies have meaningfully changed in 40 years and Volcker's extraordinary monetary tightening may not be warranted today. But one should seriously question whether the current real fed funds rate will slow the economy let alone curtail inflation.

Some economists defend the Fed's timid actions by suggesting inflation will cool once current supply chain bottlenecks subside. However, supply disruptions have been the root cause of the US's worst bouts of inflation. The oil embargoes of 1973-74 and 1979 fostered a full-blown wage and price spiral.

Importantly, today's supply disruptions have already lasted longer than the 1973-74 and 1979 oil embargoes combined and supply chains still remain snarled. It is remarkable how investors, and the Fed for that matter, are playing down one of the most significant economic events in US history.

Regardless of whether supply is constrained or demand is too strong, inflation simply reflects demand greater than supply for an extended period of time. The lesson of the Volcker Fed was that the central bank has limited ability to increase the supply of goods or labour, so the only way it can stymie inflation is to raise interest rates enough to destroy demand and force a recession.

Despite history, the current Fed believes it can engineer a so-called "soft landing" — ie inflation returning to more benign levels without a recession. The Fed's optimism has spurred discussion whether a recession will occur or not.

That current hard versus soft landing debate though seems a false dichotomy. A third outcome might be that the Fed does not act vigorously enough to force any cooling of the nominal economy and inflation lasts longer than the current consensus.

The markets seem to be considering this third option. The three-month to 10-year yield curve is the steepest in seven years, with investors demanding more returns for holding longer-term debt. Such a steepening during a tightening of monetary policy suggest the Fed is losing, not gaining, inflation-fighting credibility.

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The combination of a timid Fed, substantial inflation, and investors' general underweighting of traditional pro-inflation assets seems to present an investment opportunity.

Although investors have somewhat gravitated to traditional hedges such as inflation-protected Treasuries and Real Estate Investment Trusts, investors remain broadly underweight assets that benefit the most from inflation: energy, materials, and industrial stocks, lower-quality credits, commodities and commodity-related countries, gold, and real assets such as timberland, farmland, and trusts that offer income from royalties.

The Fed wants to be viewed as a conscientious inflation fighter, but the extremely negative real fed funds rate says otherwise. Despite the Fed’s jawboning, they are what their real fed funds rate says they are.

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