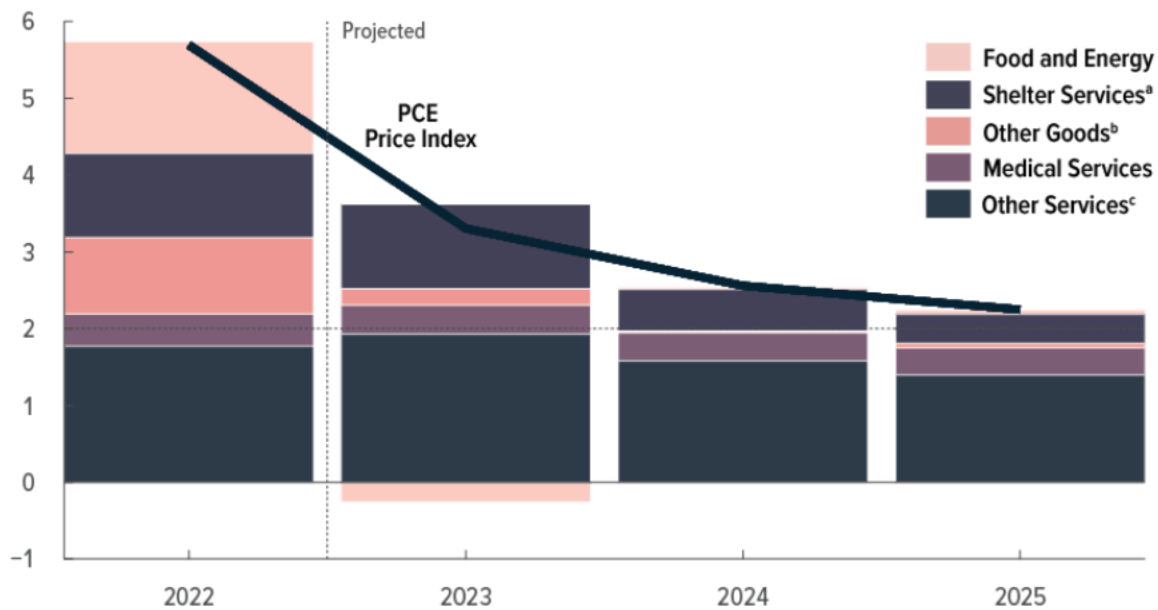
Trump Is Likely to Get His Way on Interest Rates

The United States President has made no secret of the fact that he dislikes our sitting Federal Reserve Chairman. Even since before taking office, he was hinting at the fact that he sought a change in policy, and if lower interest-rates were not in the making, that he would seek a change in leadership. While the legality of the latter is currently unclear, the President is not wrong to question the merits of keeping interest rates higher in the current environment.

To assess the situation more accurately, it can be helpful to explore the Fed's mandate from Congress. The Fed is known to have two objectives which are equally important: 1) full employment, targeting an unemployment rate of around 4%. Unemployment rates materially higher than 4% should cause the Fed to focus more on the employment mandate. And 2) inflation – there has been a formal inflation target of 2% set for years. The Fed is known to focus on a metric called "core PCE," which is supposed to ignore volatile components of inflation such as food and fuel (in actuality, due to the fact that energy costs filter into practically everything, this is not really true, but it is possible to filter out costs of gas at the pump, to some extent.) Jay Powell's interpretation of his mandates has been relatively clear. What he says is that "he focuses on whichever part of the mandate is farther from its goal…" in other words, if unemployment were farther from its 4% target than inflation was from its target, he would focus on easing Fed policy in order to help the jobs market, and vice versa. If inflation were far above 2%, and unemployment was well-behaved, he would focus on keeping interest rates high to quell demand and bring prices down.

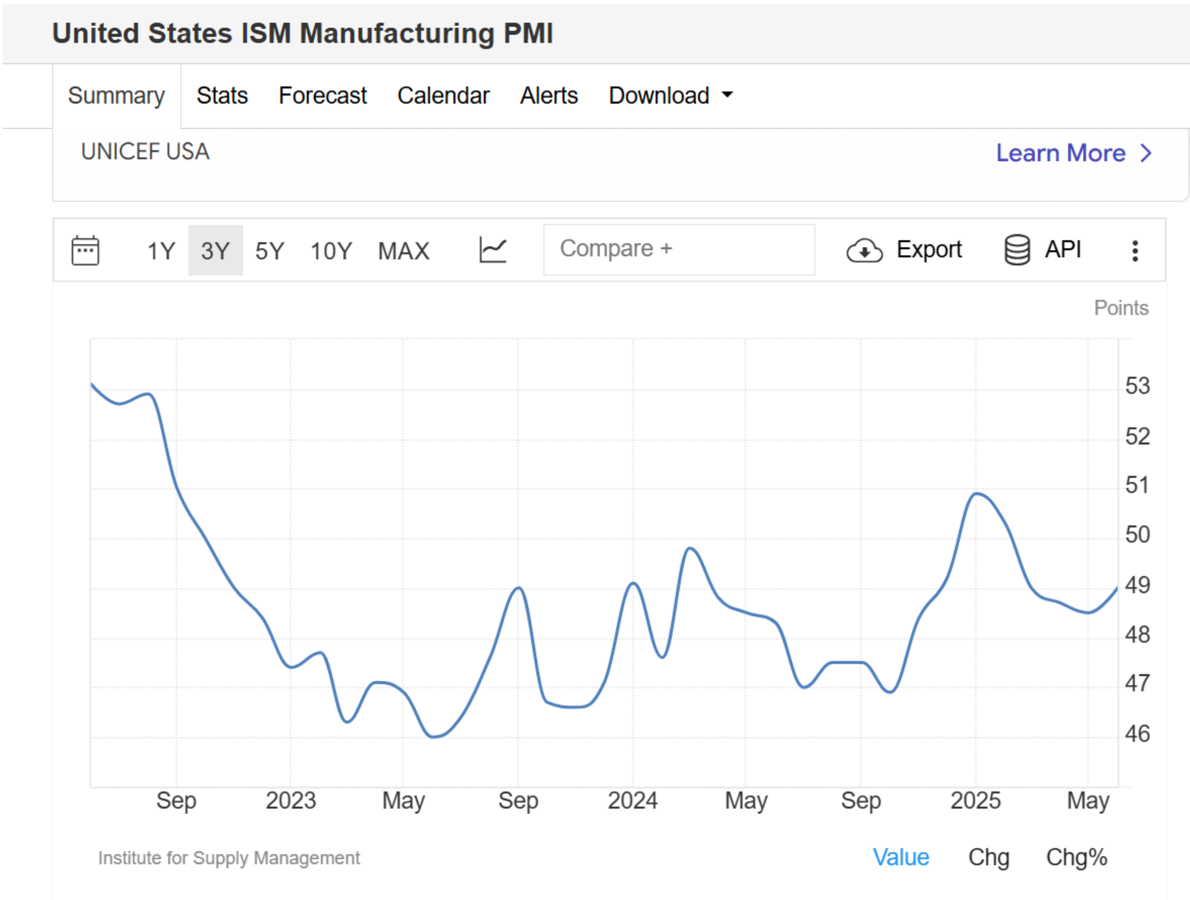
The issues with the data-driven approach that Powell et al have adopted are twofold. First, the data are backward-looking. We know from the nature of the data, that nearly all of the excess-inflation (i.e. inflation above 2%) was caused by just a handful of items, including the cost of housing (rent, owner's equivalent rent, according to the CBO chart below).



(Source of above chart: https://www.cbo.gov/publication/59431)

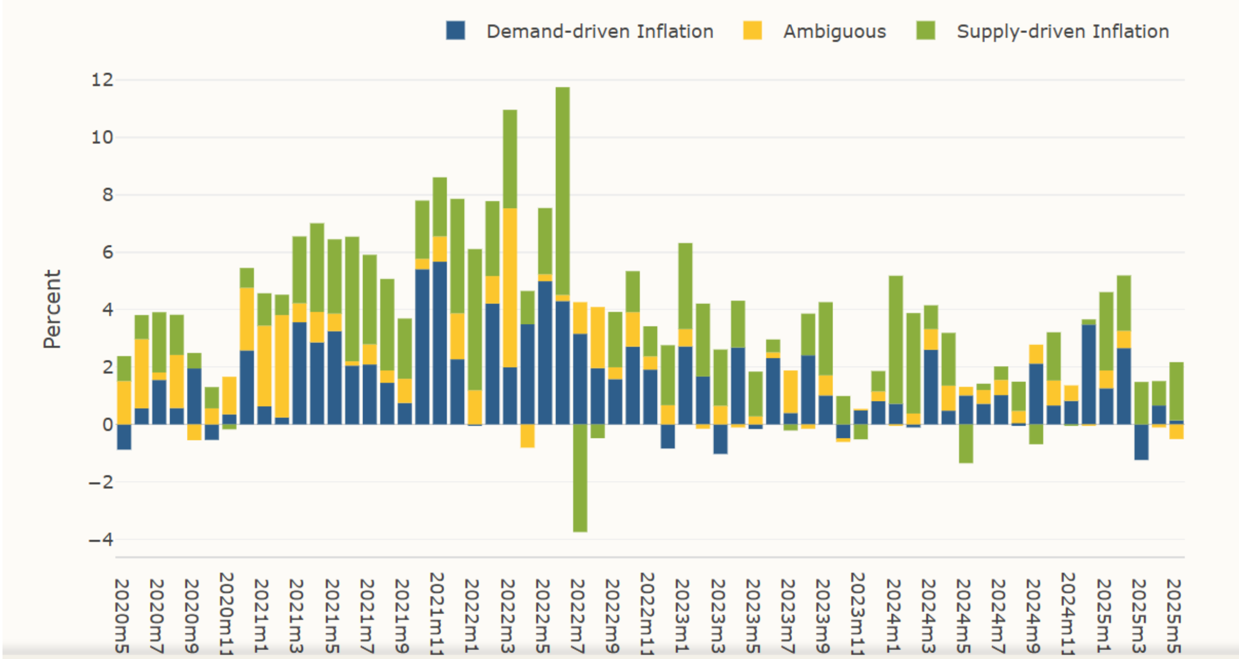
There is no guarantee that the causes of inflation going forward are going to repeat. In fact, to focus on what inflation has done, versus what it is likely going to do, could cause erroneous and unnecessary policy errors. But the idea of "looking ahead" also introduces an inconsistency in policy that is probably inappropriate at this time. Powell has said, "if it were not for the tariffs, we could cut interest rates right now…" (CNBC article about Fed Rate cuts, absent Tariffs)the fact that he would move from a data-driven, rearview window policy to a less-data driven, more forward-looking policy, just at a time when it almost seems appropriate to be cutting rates, by traditional metrics, calls into question the validity of changing the approach at this particular inflection point. To complicate the matter further, changing the approach at this point in time raises the possibility that he is "acting more independent than he needs to" out of fear, in order to prove that he will do the opposite of what the President says to do, rather than doing the most appropriate thing for the American people. These considerations should be irrelevant, as far as what the ultimate policy decisions will be.

If one simply examines interest rates, on their own, within the context of the Taylor rule, one would observe that the US interest rates are in very "restrictive" territory right now. In layman's terms, interest rates are too high, and we could afford to bring them down, because the cost of capital is prohibitive, and is already hampering economic growth. Morningstar, an independent financial research company, believes the Fed still needs to lower short-term interest rates by 200 basis points, or eight interest rate cuts of .25% (Morningstar Article on Path of Fed Funds Rate) in order to get to a more "neutral" interest rate. With mortgage rates still hovering up near 7%, it's no secret why "rates are still too high" for many Americans. However, the catch-22 here is that interest rate policy may be taking a longer-than-usual time to filter into the economy. Many homeowners are "locked-in" to mortgages in the 3-4% range (Breakdown of Mortgage-Owners by Rate - Realtor.com), and those lower rates are hard to give up, even if the homeowner wants to move homes. New buyers, on the other hand, have effectively been priced out of the current housing market. The entire interest rate complex is putting a deep freeze not just on the enormous housing market, but also on the market for new and used autos, and basically anything that Americans would traditionally finance (for farms and other businesses, this may include capital equipment, such as John Deere tractors or heavy machinery to run any industrial business.) It's not hard to see why, therefore, the industrial economy remains in recession, and why confidence is not high among business owners.

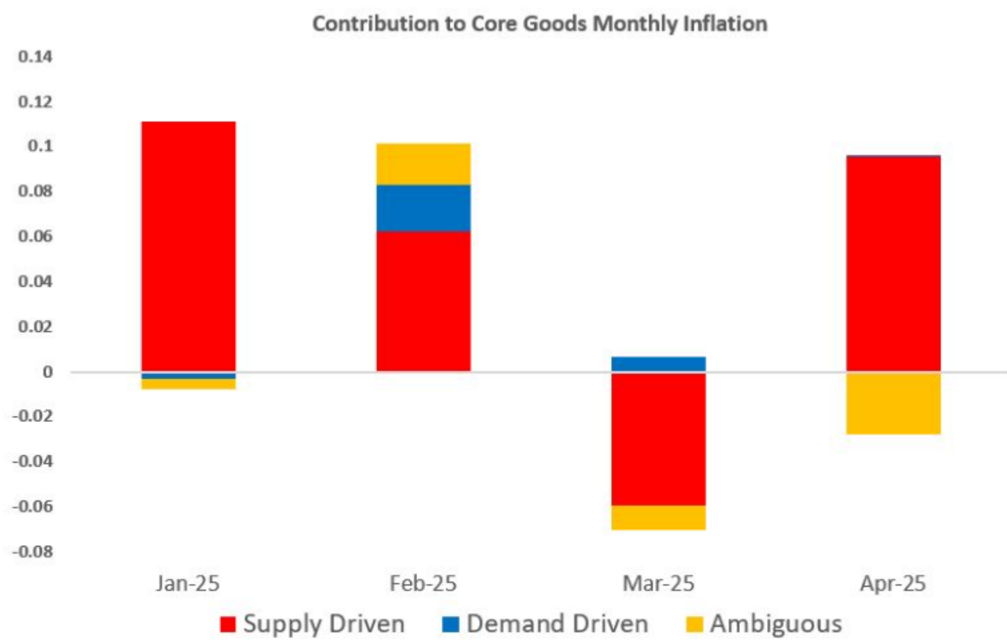


(Chart for Industrial PMI) Furthermore, if we study the history of the Fed, we know that their 2% inflation target is a number they basically stole from the central bank of New Zealand. Why, we have no idea. There is academic merit to an inflation target, but there is no definitive proof that 2% is the best number, nor is there any proof that holding interest rates higher actually helps calm inflation down. In fact, a recent SF Fed paper (SF Fed Paper - Supply-Driven Inflation) introduces the likelihood that almost all of the 2022 COVID inflation was supply-side driven (i.e. caused by supply-chain snarls, and such) – under this scenario, it is questionable what type of impact raising rates would have, and it could actually have exacerbated inflation, since higher interest rates themselves cause financial inflation in mortgages, auto-loans, and credit card debt.

Figure 1: Supply- and Demand-Driven Contributions to Annualized Monthly Headline PCE Inflation



([SF Fed Paper Cited Above]) There is some evidence of persistence to this problem – i.e., inflation in core good being attributable to supply shocks (i.e., unlikely to be solved by punitive interest rate policies). See the chart below from the SF Fed:



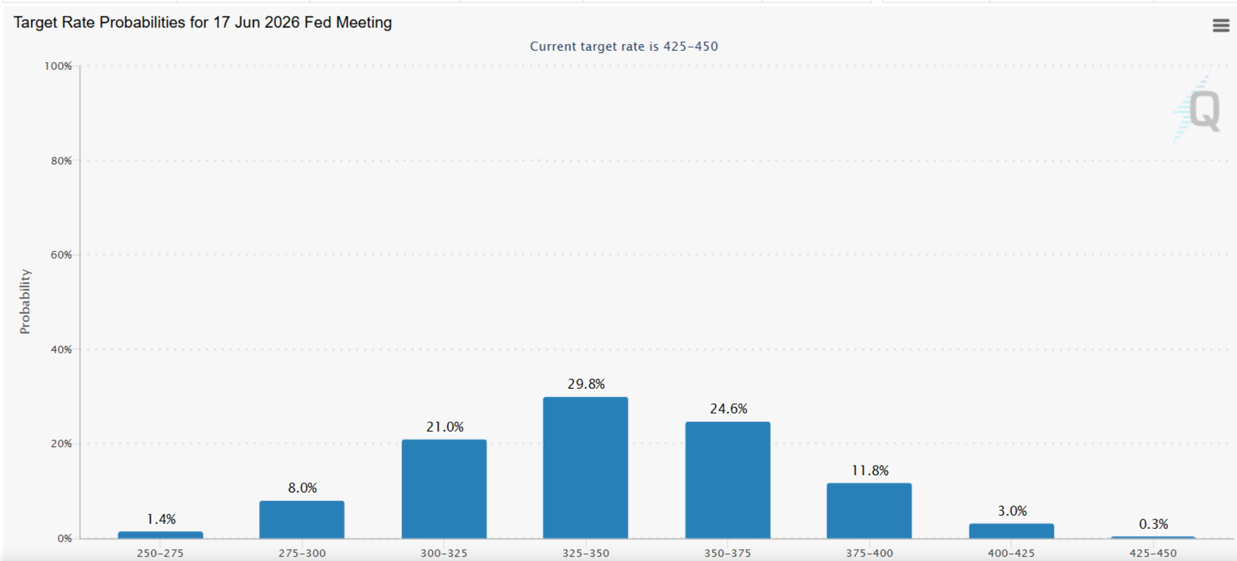
(LinkedIn Post)

How it Plays Out

My belief is that the Fed Chairman, who now has a year left in his position at the Fed, is squarely focused on his legacy. He is determined not to go down in history as the man who let inflation come back. That is why he is focused, in my opinion inappropriately, on the possibility that inflation will return vis-a-vis tariffs – rather than lean back on the prior data dependency. It is clear that in a steady state environment, Powell will be replaced by a dovish Fed leader next year. The question is whether or not a "shadow Fed Chairman" will be installed between now and then. In either scenario, shorter-term rates should be coming down, not going back up. With housing costs and auto-insurance costs no longer the main drivers of inflation, and with oil prices tame in spite of a significant middle-east escalation, it is difficult to foresee where an unexpected inflation shock might come from. The market for interest rate "futures" is pricing in several cuts before the end of the year.

Kaizen Wealth Strategies

MEETING INFORMATION						PROBABILITIES		
MEETING DATE	CONTRACT	EXPIRES	MID PRICE	PRIOR VOLUME	PRIOR OI	EASE	NO CHANGE	HIKE
17 Jun 2026	ZQM6	30 Jun 2026	96.5525	4,210	8,609	99.7 %	0.3 %	0.0 %



When interest rates do eventually go down, it will be very good for aggregate demand. Foremost, there will be many refinancings of mortgages and new mortgage initiations, as many who've been sidelined due to higher rates come off the sidelines as buyers and sellers. I believe that the housing activity could be significant, and could lead us out of the industrial recession we have been in. As housing turnover increases, it is unclear whether there will be more buyers or sellers. The answer to this question will determine whether home prices go up or down, and the ultimate impact on the "wealth effect," (whether folks feel richer or poorer.)With all of the talk of A.I. nowadays, many questions are raised about the Fed, their independence, and potentially better policies for interest rates. It is a widely accepted view that Jay Powell was about a year late in raising interest rates to fight inflation. In spite of the data telling him to do so, he "looked through" the inflation as transitory. Could a more automated system have solved this problem by simply matching inflation increases in real-time, with rate increases, and decreases with decreases? If robots can replace factory workers, why can't a simple algorithm take the job of the Fed? Wouldn't it eliminate the question of politics and bias? It is worth exploring, since nobody wants to have to experience the pain of 9% inflation and crushing interest rates, ever again.

The blunt instrument of interest rates are perhaps not the optimal way to manipulate the economy. The way that economic cycles would progress in the past was often dictated by interest rates. That's because the US economy, especially the industrial part of it, which is highly interest-rate dependent, can have a high beta to interest rate moves. Rapid increases in interest rates, driven by tightening policy, have led to industrial recessions and therefore economy-wide recessions. Recessions were viewed as necessary "medicine" to lower aggregate demand and lower inflation. But the question remains, if getting inflation under control is the goal, are there better ways of achieving this? Why not schedule payments to be sent to those citizens most affected by inflation? Wouldn't this cost less to the US economy than the printing of several trillions of dollars of stimulus? Certain classes of goods or services that are most-affected by inflation could be eligible for purchase by certain "stable-coins" developed by the treasury for use specifically for low-income people who need help on inflation. These stablecoins could be issued to the affected cohort with minimal interruptions to the rest of the economy.

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