

# Inflation, the Fed's dilemma, and the stock market

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# Roadmap

- How are inflation and stock prices related? Interest rates and the Fed
- Current inflation rates: Historically high, broad-based
- Future monetary policy: Higher interest rates
- Open questions:
  - How high will interest rates go? How quickly?
  - Will this cause a recession? If so, how severe?
  - How will interest rates move equity prices?

## The connections



- The **Fed** responds to inflation by changing interest rates
- **Markets** respond to interest rates, changing stock prices

# The Fed's dilemma



- The Fed's "dual mandate"
  1. Low, predictable inflation
  2. Full employment: fight recessions
- The Fed's tool: interest rates
  - High inflation: raise rates (recessionary)
  - Low employment: lower rates (expansionary)

# Markets



- Ways to save
  - Lend money (bonds)
  - Buy shares of firms (stocks)
- When interest rates rise,
  - Lending is more profitable
  - Firms' profits may deteriorate (except financials)
- Demand fewer stocks, which lowers the price

# Markets and expectations



- Stocks, bonds, loans are *forward looking*
  - If rates will change in the future, respond now
- Expectations of the future are important
  - Managing expectations is another Fed tool
  - Complication: Fed guidance is related to future economic conditions, too
- FOMC rate predictions for 2022 (median)
  - Mar 2021: 0.1 percent
  - Dec 2021: 0.9 percent

# Interest rates on U.S. Treasuries (percent)

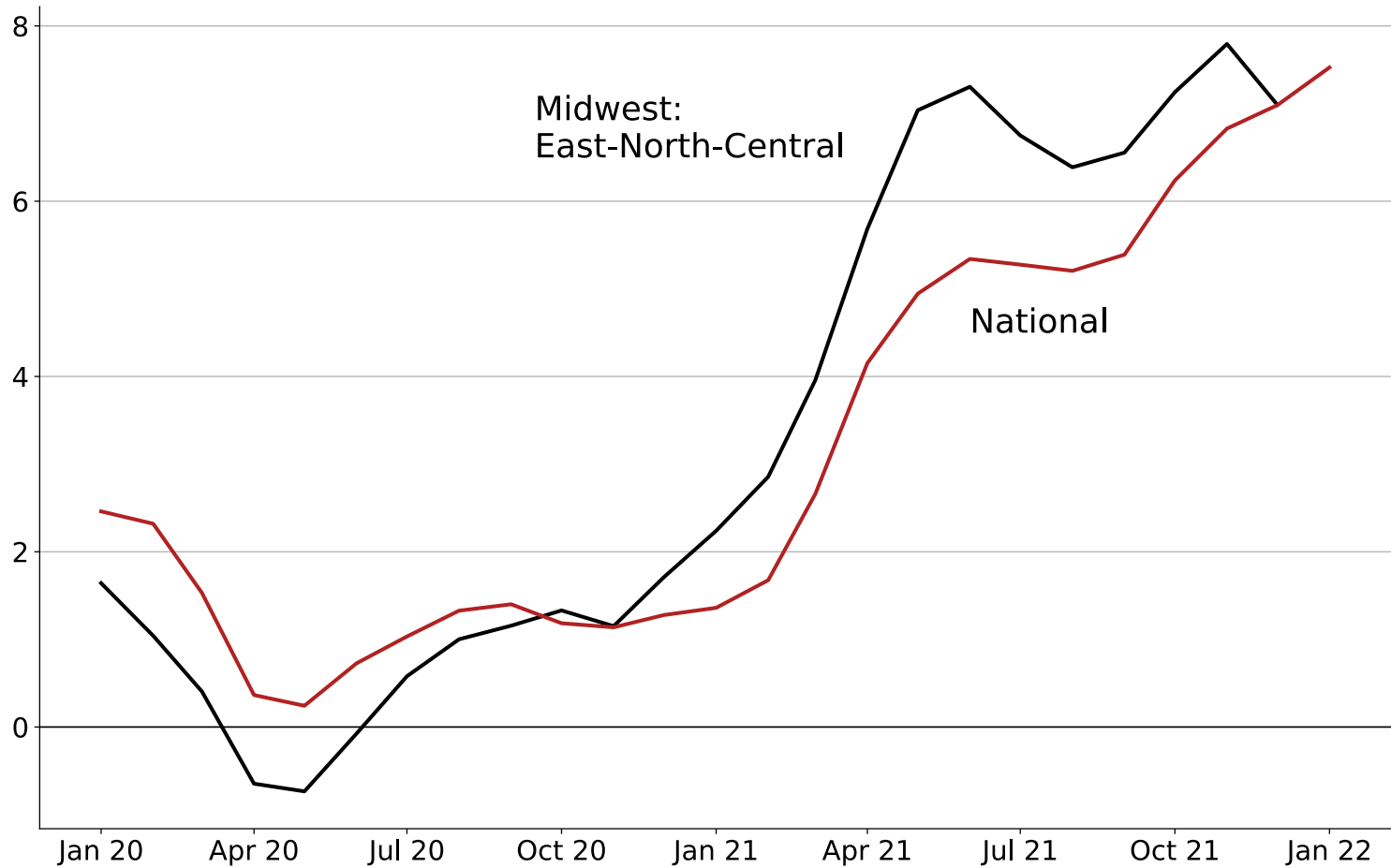


CPI Inflation rate (year-over-year, percent)

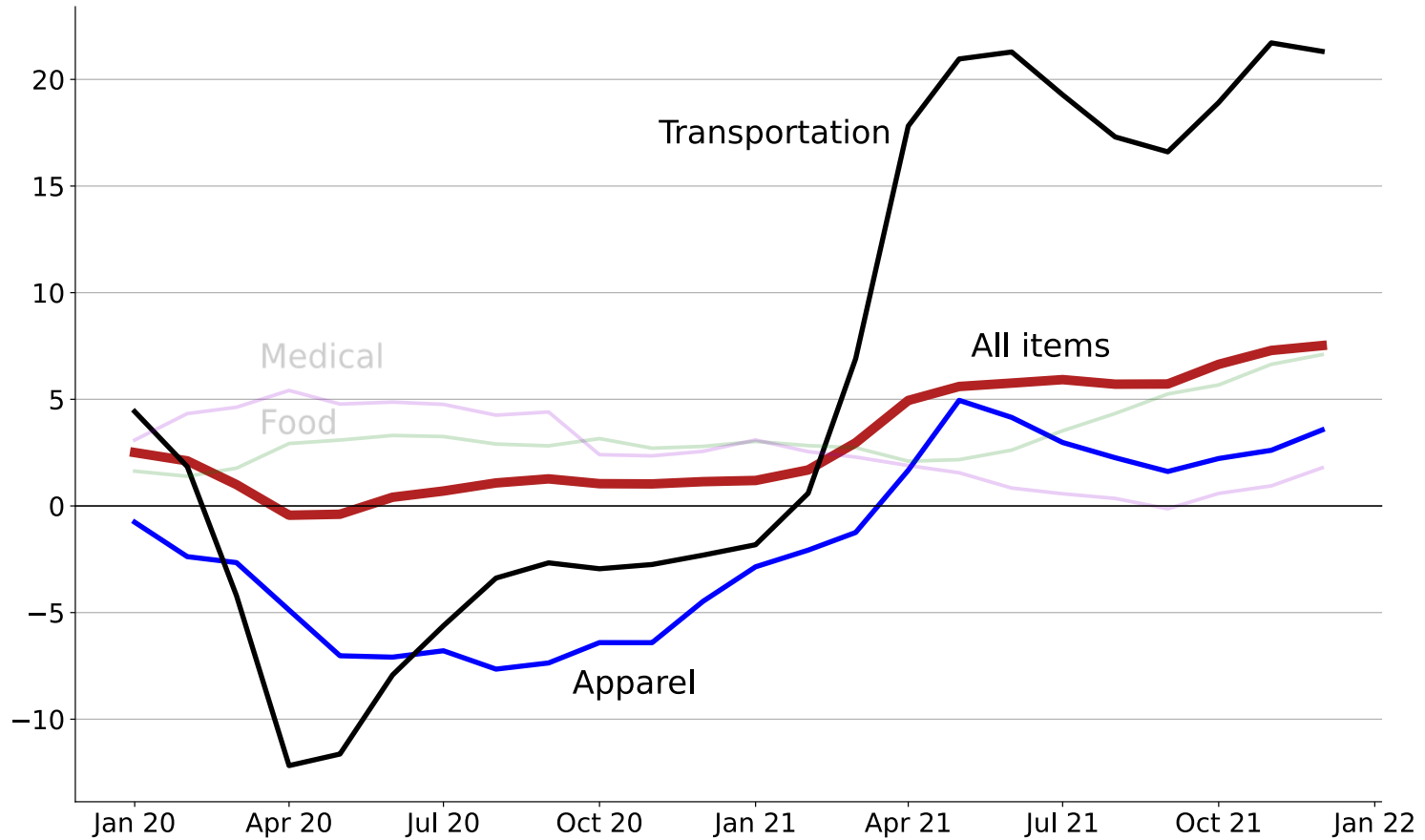




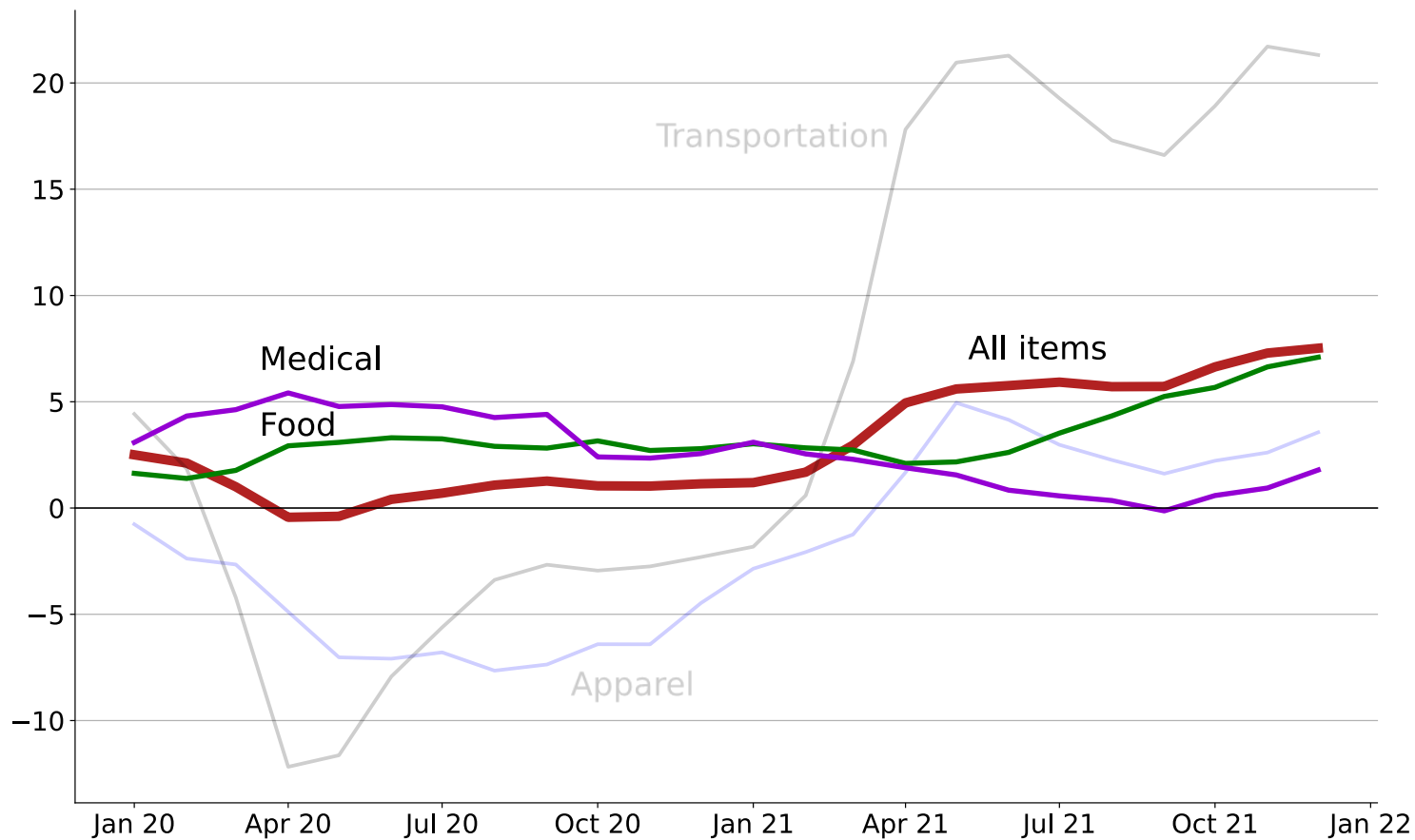
# CPI Inflation rate (year-over-year, percent)



Inflation rate by sector (year-over-year, percent)



Inflation rate by sector (year-over-year, percent)

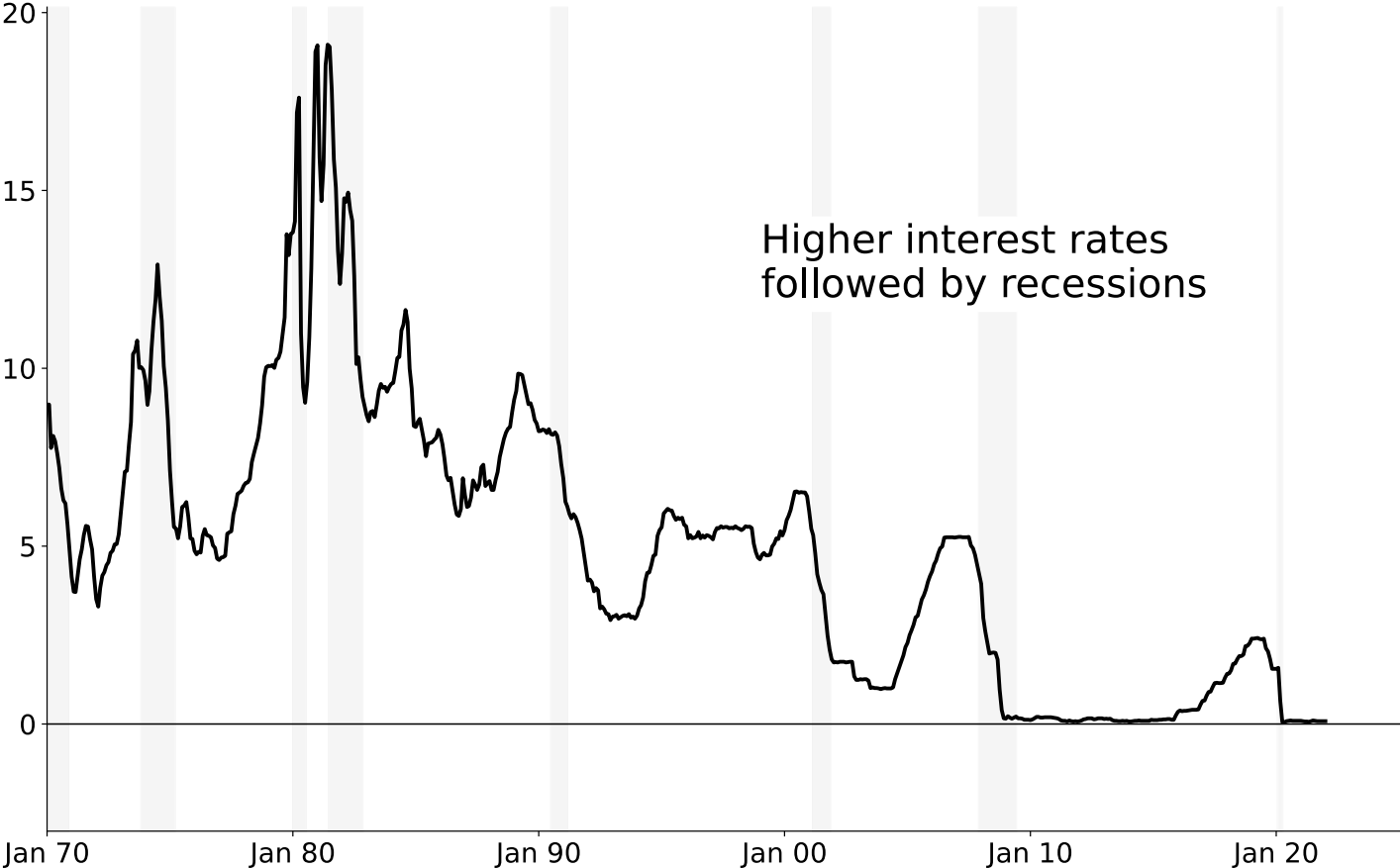


# Why inflation now?

- Increasing demand
  - Deferred covid spending
  - Stimulus
- Decreasing supply
  - Transportation backups
  - Production problems (including hiring difficulty)



# Federal Funds Rate (percent)



CPI Inflation and Federal Funds Rate (percent)

