Cadence Bank Podcast: In Good Companies

Season 2 Episode 1: Inflation: The Future of Interest Rates

Welcome back to *In Good Companies*! This season, we're exploring the forces shaping your business, inside and out—and to kick off Season Two, we've got a double whammy: inflation *and* interest rates.

During COVID, the Federal Reserve cut its target range for the Federal Funds Rate to 0.00% to 0.25%. But now, in 2022, inflation has hit a 40-year high and interest rates are climbing again. In six short months, the Federal Funds Rate target range has risen steeply, from a range of 0% to 0.25% to a range of 3.00% to 3.25%. High interest rates can have a substantial effect on businesses and consumers alike. So, how high will rates climb? And how long will they stay elevated?

One of the people best positioned to answer those questions is Dr. Lindsey Piegza, Chief Economist at Stifel: she's spent her career translating the economy to a broad audience. Together, we'll examine the relationship between interest and inflation, decode the Fed's monetary policy and explore why this inflation might be particularly stubborn.

As always, we'll dig into what this means for you and your business: what indicators to pay attention to, how to adapt to a high-interest environment and why you should be especially cautious when inflation recedes.

So join us! We've got your best interest at heart.

Episode Transcript:

[00:00:00] **Patrick Pacheco:** I hate to do this, but one economist joke. So how many economists does it take to change a light bulb?

[00:00:08] **Dr. Lindsey Piegza:** Well, I'm guessing you're going to say quite a few.

[00:00:13] **Patrick Pacheco:** None. If it needed changing, market forces would've changed it already.

[00:00:17] **Dr. Lindsey Piegza:** Economics is surprisingly enlightening.

[00:00:20] **SFX:** Theme music in

[00:00:21] **Dr. Lindsey Piegza:** Higher interest rates, higher borrowing costs, higher prices for labor and parts and materials—all of these factors will compound pressure on businesses, particularly small businesses struggling to maintain a positive profit.

> [00:00:37] **Patrick VO:** Inflation and interest rates have risen significantly. Are we close to the peak, or will they continue to climb? And what does it mean for your business?

[00:00:45] **Dr. Lindsey Piegza:** In fact for some, higher interest rates and costs will likely lead to a slowdown in hiring, a reduced level of investment. Some businesses could be forced to close their doors altogether.

[00:00:58] **Patrick Pacheco:** I'm Patrick Pacheco and you're listening to Season 2 of *In Good Companies* from Cadence Bank, the podcast where we guide you through the forces shaping your business, inside and out.

[00:01:10] **SFX:** Theme music out

> [00:01:12] **Patrick VO:** Inflation: it's growing.

[00:01:13] **SFX:** Sound of a balloon being inflated.

> [00:01:15] **Patrick VO:** In June 2022, inflation hit a 40-year high: 9.1%. In response, interest rates are rising fast, which has an enormous impact on business. High interest rates affect your access to capital, consumer behavior and, therefore, company strategy. The difference between 4% and 6% interest could dictate your company's growth plans. So how high will interest rates go? For how long? And what can you do to adapt?

[00:01:37] **SFX:** Sound of balloon losing air.

[00:01:39] **Patrick VO:** To see where interest rates are headed, you have to understand their relationship with inflation. But when you start discussing monetary policy, things can get very complicated, very quickly. So to help us navigate the world of inflation, we brought in a heavy hitter.

[00:01:57] **Dr. Lindsey Piegza:** Hello, my name is Dr. Lindsey Piegza, and I am the Chief Economist at Stifel.

[00:02:02] **Patrick Pacheco:** I don't know that kids are born and they say, "You know, I think I'll become an economist someday." How did you get there? I'm curious about your path.

[00:02:09] **Dr. Lindsey Piegza:** Well, maybe some children are born with the desire to be Chief Economist, but for me it was a bit more unexpected, to be honest. From a very young age, I actually wanted to be a medical doctor. I studied Latin for years and in preparation I actually went into college as a biochemistry major.
However, when I took Economics 101 as an elective and the professor put the chart of supply and demand up on the blackboard, all of a sudden, things seemed to make sense. I changed my major the next day and pursued an education and later a career in economics.

[00:02:46] **Patrick VO:** Dr. Piegza is the perfect person to break this subject down, because decoding the economy is part of her job description.

[00:02:53] **Patrick Pacheco:** Chief Economist, that's quite a title. What exactly does being a Chief Economist entail?

[00:02:58] **Dr. Lindsey Piegza:** Well, there's several aspects to my role. First and foremost, I really like to think of myself as a translator. I translate everything that is happening in the economy, in the markets, in domestic and international policy, both monetary and fiscal policy, and really boil that down so that our sales force and our clients can better understand what's happening in the economy, and by extension then, they can make better, or better-informed, decisions for their investments.

[00:03:27] **Patrick VO:** We need a guide like Lindsey because our current economic situation is deceptive. What feels like a return to normal after COVID is potentially the pendulum swinging in the other direction.

[00:03:40] **Dr. Lindsey Piegza:** When we look at top-line GDP growth, for example, that has been trending negative for the past six months. When you look at consumer spending, yes, it's still positive, but we're down near 2% off of an 8% average pace from last year. And even further down from that double-digit percent increase, as we saw, the reopening of the economy. Manufacturing activity, yes, is still in positive territory, but nearer that break even rate. We've seen a significant loss of momentum there as well. The housing market is beginning to turn over, and while wage growth is positive on a nominal basis, we talk right now about 5% plus annual wage growth. When we take that against the backdrop of 6, 7, 8% inflation, all of a sudden that 5% increase doesn't feel so good. And real income growth has actually been trending negative for the better part of the past year. So I think it's very clear that rising levels of inflation, coupled with increasingly hawkish monetary policy, is already having a very significant downward impact on the economy and nearly every sector of the economy.

[00:04:48] **Patrick Pacheco:** It's interesting because there's a whole set of people from, maybe age 30 on, or maybe it's 35 on, that have never seen inflation. I mean, not inflation like this. When I was in school, I was studying economics. My parents, we bought a new house and the mortgage was 9.75% and they were ecstatic they got such a great rate. We haven't seen that in so long. I think it shocks some people and some people are just maybe blissfully ignorant of what's happening.

[00:05:19] **Patrick VO:** Inflation is not a new phenomenon. But *this* inflation is unusual--in part due to the country's pandemic response.

[00:05:27] **Dr. Lindsey Piegza:** There was a significant ratcheting up of fiscal initiatives and stimulus spending. In total, we spent nearly $6 trillion. We spent more than double the next largest spender, with many of those initiatives or much of that stimulus coming out in the form of direct checks to individuals and businesses.

So while all of the developed world is contending with those supply side constraints and supply side pressures, in the US, prices in the aftermath of COVID were higher than most anywhere else in the world, because not only did we also have those supply side pressures, but we had the compounding influence of demand side inflation as a result of trillions and trillions of dollars flooding into the marketplace.

[00:06:14] **Patrick Pacheco:** So when we talk about inflation, we often tie that concept to interest rates. Why is that?

[00:06:20] **Dr. Lindsey Piegza:** Well, typically when we refer to rates, we're talking about the key lending rates of the US Central Bank, the Federal Funds Rate. And for this, the Federal Reserve sets a target range. Now to be clear, the Federal Reserve doesn't actually set the effective rate. That's set by the most basic principles or forces of supply and demand in the marketplace, calculated as the weighted average of all the interest rates that banks pay when they borrow from other banks in the country. But the Federal Reserve does set the desired range for the Federal Funds Rate and conducts open market operations, or buying and selling of securities, to reach that target. Now, why is this so important? Well, the Federal Funds Rate, as I mentioned, is the interest rate that banks charge each other to borrow money overnight. So while, yes, the federal funds rate or interest rates directly apply more precipitously to banks, indirectly the Federal Funds Rate influences the interest that we pay on a variety of loans and investments. Everything from mortgages to small business loans to personal loans. Even the interest rate on credit cards. And it's also the Fed's primary lever for addressing inflation. So this is how it ties back. When the Fed raises rates, it's aiming to increase the cost of funds, increase the cost of money, which in turn then reduces access to credit and essentially makes borrowing more expensive, which presumably then reduces investment, reduces consumption, resulting in a reduced level of economic output and a reduced amount of money circulating in the market. And so, all of this then finally leads, presumably, to a reduced level of inflation, or at least in this case, a slower pace of still heightened price growth as we're seeing in the marketplace.

[00:08:22] **Patrick Pacheco:** So, it's interesting. It seems that inflation is a driver of interest rates and yet interest rates then turn around and become a driver of inflation. Is that correct?

[00:08:34] **Dr. Lindsey Piegza:** Absolutely. So the higher that inflation rises, the more likely the Fed is to come into the marketplace with traditional monetary policy to raise interest rates to address that heightened level of prices, to tame inflation back down to a more palatable level, resulting in a scenario where the Fed can then allow the market to reduce the cost of borrowing.

So it's a very cyclical nature of prices and interest rates, or a very cyclical nature of a relationship, between the two.

[00:09:03] **Patrick VO:** So that's the theory. And so far in 2022, the Fed has been putting theory into practice.

[00:09:09] **Patrick Pacheco:** So the Fed has used that power multiple times this year to try to affect inflation. Can you walk us through the various raises that we've had, the increases, and how they've moved and why they've moved the direction and the size that they have?

[00:09:24] **Dr. Lindsey Piegza:** Well, at the onset of the crisis, the Fed opted to implement emergency measures, taking the target range of the Federal Funds Rate down to zero, where it remained for, let's call it, about two years, from March of 2020 to just about March of 2022. And as you may recall, in March of this year, the committee then strongly reversed their assessment of the economy, their assessment of inflation, and the need for further accommodation. And so, it was earlier this year that we implemented that first interest rate hike since 2018. So in March, the upper bound of the Federal Funds range was increased from a quarter percent or 25 basis points to a half a percent or 50 basis points. Two months later in May, the Fed opted for an even larger increase of 50 basis points, or again a half a percentage point, taking that upper bound to a full 1%. And by June, with inflation still at a very elevated level, the Fed thought it was appropriate to increase rates by an even larger increase, 75 basis points. And this was the largest single meeting increase since the early nineties. And then we saw two more 75 basis point increases in July and, of course, more recently in September, taking that upper bound of the Fed's target range to, now, over 3%, 3 ¼%, with a total of 300 basis points or three full percentage points of rate hikes under its belt.

[00:10:51] **Patrick Pacheco:** How much of those increases affect the economy because of the increase? And how much of it is the message that it's a tool of communicating? Do you think the communication aspect of it is just as strong as the market force that it exerts or is one stronger than the other?

[00:11:08] **Dr. Lindsey Piegza:** I would argue that it is less about that shock effect or that larger impact, and more about communicating a longer-term position by the Fed to the marketplace. I think right now, what the Fed is telling us is that with both the consistency of raising rates and the ongoing acceleration in the size of rate hikes... As I just mentioned, we moved very quickly from 25 to 75 basis points per meeting. I think the Fed is very clearly trying to send two messages. First, that the committee remains extremely focused on reinstating price stability. This is what the chairman of the Federal Reserve has deemed the bedrock for the economy. So first and foremost, the Fed is trying to posture a very hawkish position for the marketplace to convince investors that they are going to stay the course. But I think the second message is that inflation is markedly more stubborn and remains persistently higher than previously anticipated. So I do think at this point, the Fed has been very clear that they would rather err on the side of raising rates too much and slowing the economy too much, rather than falling behind the curve and allowing inflation to get out of control.

[00:12:24] **Patrick Pacheco:** Is there any chance that they pull back rates at any time soon, or is that probably way out in the future?

[00:12:29] **Dr. Lindsey Piegza:** Well, the Fed has indicated a new forecast rate of around 4 ½% by the end of the year and a terminal rate, a final rate, of 4.6% sometime next year, meaning 2023. And I do think this is a reasonable expectation. However, given the persistent nature of inflation, I am somewhat skeptical that the committee will be able to reverse course after reaching that terminal rate and offering the first rate cut by 2024 as the committee and the market seems to be anticipating. So the factors that are really going to determine whether or not the Fed will be forced to hold steady or continue to raise rates, in my mind, number one is inflation. Again, the Fed has been crystal clear that the Fed will continue to raise rates until inflation has shown a market retreat. If inflation remains stubbornly elevated and the Fed is convinced that it can have a further influence on prices, it will likely be willing to raise rates above the current outlook. Of course, should inflation begin to subside more rapidly than expected, I would presume that the Fed would equally be willing to leave the Fed Funds Rate lower than indicated. So first and foremost, above all else, it's going to be the longer-term trajectory of prices that determine the Fed's willingness and ability to raise rates higher than needed or keep them lower than currently projected.

[00:13:58] **Patrick VO:** The economy is complex and the Federal Funds Rate isn't an on/off switch, so it may be a while before we know if this solution is working.

[00:14:09] **Dr. Lindsey Piegza:** So, typically economists say that monetary policy comes with a sizable lag. And this is also why policy makers often take a pause or slow the pace of rate hikes earlier than one might expect, in order to take a look back and assess the full impact of earlier policy decisions. And in fact, we've heard from the chairman himself that it will likely be appropriate at some point in the future for the committee to slow or reduce the pace of subsequent rate hikes in order to assess the full impact of earlier 300 or more basis points of increases since March.

[00:14:47] **Patrick Pacheco:** And so, would we expect that you see a reduction and then maybe a pause and see how it all shakes out? What would be the potential for them to start back up? What would they be looking at to have additional increases?

[00:14:59] **Dr. Lindsey Piegza:** Well, at this point, according to the September Summary of Economic Projections, or the SEP, most of the committee members are anticipating 125 basis points more of tightening by the end of the year. Now, that being said, just as many officials actually anticipate a hundred basis points or less of additional tightening through year end, which would imply a potential for a smaller rate increase of just 50 basis points by the next meeting, and then a second round 50 basis point increase in December. So we could be seeing the potential for already a reduction in at least the size of rate hikes, sooner rather than later. But I would say broadly speaking, whether we see 125 or a hundred basis points between now and the end of the year. At the very least, I think that Fed officials are already talking about, again, not arresting further rate increases altogether, but I think the discussion for the potential of reducing the size of subsequent rate hikes is already being had among, at least, some Fed officials.

[00:16:04] **Patrick VO:** Whether rate hikes taper off or continue to rise, the unusual nature of this current inflation poses some difficult questions for the Fed.

[00:16:13] **Patrick Pacheco:** So what happens if inflation doesn't subside?

[00:16:17] **Dr. Lindsey Piegza:** It's the million dollar question. Will Fed policy work? Will continuing to raise the cost of borrowing actually return us to more stable inflationary and economic conditions? And it's a very difficult question to answer, because typically the Fed is raising rates when the economy is overheating. But this time around, the economy is not overheating. This time around, as I mentioned, the economy is already trending negative and has been for the past six months. So, momentum is still on this downward trajectory. Momentum has slowed markedly. But further complicating the scenario for the Fed, is the arguably inorganic nature or complicated nature of inflation, with a good portion of price pressures stemming from the supply side of the equation. So while raising rates or raising the cost of borrowing can, again, influence the demand side of the equation, what impact does higher borrowing cost have on supply side pressures? Arguably little if any, so this essentially renders traditional policy metrics, i.e. raising rates, less effective in controlling inflation this time around. Remember, the Fed can't print more ships or negotiate resolution to the Russia/Ukraine conflict. Or, more importantly, the Fed can't change China's Zero-COVID policies. So the Fed will struggle this time around more so to tame inflation on the demand side, but supply side pressures are arguably outside of the Fed's control.

[00:17:56] **Patrick Pacheco:** What other levers does the Fed have to try to do something? Or do they have anything that would be effective?

[00:18:02] **Dr. Lindsey Piegza:** I think at this point, the Fed is going to be rendered tool-less, for lack of a better word, when it comes to those supply side constraints. Again, the demand side can be tackled by monetary policy. But in order to get global inflation back under control, we're going to need to return to some level of that structural fluidity in terms of the exchange of goods and services across international lines. And I'm not optimistic that we'll return to that free flow of goods and services for another year, two, maybe longer, if we ever get there. From a monetary policy perspective, they're going to, and they are doing, all they can do to reign in prices on the demand side. But unfortunately, there's not many tools the Fed has to address supply side constraints

[00:18:53] **Patrick VO:** Time will tell if the Fed's monetary policy will be enough to control inflation. In the meantime, though, businesses will have to deal with the environment it creates.

[00:19:05] **Dr. Lindsey Piegza:** Higher interest rates, higher borrowing costs, higher prices for labor and parts and materials—broadly speaking, all of these factors will compound pressure on businesses, particularly small businesses struggling to maintain a positive profit. In fact for some, higher interest rates and costs will likely lead to a slowdown in hiring, a reduced level of investment, or as I mentioned earlier, worst case scenario, some businesses could be forced to close their doors altogether.

[00:19:37] **Patrick VO:** But it's not all doom and gloom. With the Fed's strong communication and the built-in lag of monetary policy, businesses at least have an idea of what's coming.

[00:19:48] **Dr. Lindsey Piegza:** Often the influence or the impact of policy adjustments are felt immediately in the financial markets. But when we talk about the impact on consumers or businesses, this will take time for the full effect of a change in the Federal Funds Rate to be felt in those other areas. So stocks and bonds, these can reprice within seconds. Other types of consumer and business loans aren't updated quite as quickly. And also when we talk about this outside of the financial market, specifically, when we look at hiring investment consumer decisions, this will take a more prolonged period then to be influenced by these higher costs. So if the Fed raises rates by 25 basis points, for example, businesses may start to feel the weight of higher prices, but it may not be for months, and maybe 300 basis points later, that the weight of these higher costs force businesses to change their behaviors as a result. But at the same time, keep in mind that the impact of inflation is not always equal. And in fact, for some businesses, at least for now, inflation has not necessarily been all bad. Some businesses have actually been able to increase profits by passing along price increases as a direct result of inflation, and then some. So it's not always an equal impact, but certainly broadly speaking, I would say a continued ratchet up of borrowing costs, inability to access parts and materials, higher labor costs. This is posing a broader net barrier to growth for businesses.

[00:21:27] **Patrick VO:** Businesses also have to keep a close eye on consumer behavior.

[00:21:32] **Dr. Lindsey Piegza:** Well, first off, consumers are still spending. That's the glass half full. So, this is a welcome sign of resiliency, particularly for a consumer-based economy. That being said, consumers are spending at a noticeably reduced pace, relative to the start of the year, with weakness at this point, not only persisting, but intensifying over the past six months. In fact, several large retailers have already noted a significant change in consumer spending patterns as the household balance sheet now becomes increasingly fragile as a result of these higher costs and higher inflation. Now, for some, this means buying less overall. For some, this means reducing the quality of their purchases. So instead of buying Pantene shampoo, maybe we're now buying Walgreen's brand shampoo. And for others, particularly the younger generation, this has led to what's called binge spending, where consumers may forgo purchases for one, two, maybe even three months, beyond the absolute bare minimum in order to then buy that larger, more expensive ticket item in month four.

[00:22:42] **Patrick VO:** As money gets harder to access, from lenders and customers, Lindsey recommends paring down and focusing on resilience.

[00:22:50] **Dr. Lindsey Piegza:** For businesses however, going into this higher interest rate environment, this higher level of an inflationary environment, I think many are trying to keep a tight ship, limit overhead where possible and keep a tight grip on inventories. And now more than ever, I do think that businesses are aware of the fact that we may be in a period of high interest rates for some time. They're looking for ways to adapt and grow and compete in what will likely be a very difficult environment for some time.

[00:23:20] **Patrick Pacheco:** So those are the things you'd be advising business owners right now, is inventory management, cost control and having a plan for the future. That's what business owners can be doing now to put themselves in the best position on a going forward basis.

[00:23:31] **Dr. Lindsey Piegza:** I think so. I think understanding the fluctuation and rates, understanding that a fluctuation is inevitable, remaining well-positioned, remaining flexible and adaptable. I think that's the best advice I could offer to businesses, at this point, in this very difficult environment.

[00:23:47] **Patrick Pacheco:** So what about businesses as they start seeing the inflation pressure start to slow, and they see that we're maybe coming out of it. What do they do then? Do they stay on with the policies they put in of early watching inventory, really watching costs, or is there something that they should do differently at that time?

[00:24:03] **Dr. Lindsey Piegza:** No, I think we want to keep the same type of flexibility and adaptability, even as we see early indications of prices subsiding. Because even if we see one, two, three months of improved price pressures, I think there's a number of upside risks that will be lingering in the marketplace. For example, we have seen gasoline prices retreat markedly from a high of over $5 to down near three and a half. However, in just the past couple of weeks now, we've seen prices creep back higher, not back up to $5 a gallon, but again, the upward momentum can very easily return with volatility returning to the marketplace. And I think more recently, that unprecedented volatility that we saw in the UK marketplace is a very good reminder how quickly things can change here in the US. So the idea is, don't get too complacent, even as conditions signal in improvement from the worst case scenario.

> [00:25:01] **Patrick VO:** Even though we might be headed for a difficult stretch, Lindsey says there are reasons to be hopeful.

[00:25:08] **Dr. Lindsey Piegza:** Hardship is hardship, and we're certainly feeling that every time we fill up the family car or go to the grocery store. But we do have to put this in perspective that markets are cyclical. We do see peaks, we do see troughs. And while we are feeling an extended period of pain right now, the US economy is one of the largest, most liquid markets with one of the most entrepreneurial labor forces in the world. And so, if we are able to continue along this pathway to slay the inflation dragon lurking around the corner, I do think that we will get back onto a path to a longer term trajectory of potential GDP, much stronger GDP, down the line.

[00:25:51] **Patrick VO:** Whether it's three months or three years, a period of high inflation and high interest will be difficult. This inflation might be stubborn--global supply and demand forces have been deeply altered. But when you understand the principles behind these rate changes, you can make informed choices that may help keep you profitable through it all. Stay alert to the Fed's messaging. Be nimble and adaptable--the time might not be right for big growth projects. Keep an eye on consumer behavior and adjust accordingly. Don't lose focus at the first sign of price relief. And remember: this won't last forever. Stick to this blueprint, and you'll still be strong when we come out the other side.

Thank you to Dr. Lindsey Piegza of Stifel for giving a good name to economists.

[00:26:13] **Patrick Pacheco:** In Good Companies is a podcast from Cadence Bank, member FDIC, equal opportunity lender. Sheena Cochran is our production coordinator. Our executive producer is Danielle Kernell, with writing and Production from Andrew Ganem and sound design and mixing by Ben Cranell at Lower Street Media.

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[00:27:20] **Outline:** **Disclaimer**