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Why Not Cut Rates Now?

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Are tariffs inflationary? Like most asset managers, I have been contemplating the impact of tariffs on the economy along with likely market outcomes, and so far my answer to this question is, "Kind of, but not really."

Tariffs are a tax on foreign goods and services. If a foreign product faces a 10% tariff, then really there are two options for who ultimately pays. On one hand, the price of the product can be increased, which passes the cost of the tariff on to the consumer of the country that enacted tariffs. That would be inflationary, by definition, since inflation measures the average price increase of things. On the other hand, if the tariff paid is not passed through to consumers via increased prices, then it effectively comes out of the profitability of the selling company and likely those companies in the supply chain of making that product. This would not be overtly inflationary and could actually reduce economic growth and potentially lessen demand.

Trump's policy is broad-based tariffs on virtually all imports, and so the answer is that both scenarios are likely to occur – consumers bearing higher prices directly, as well as producers eating costs with reduced profits.

I would argue that even though prices are likely to go up a bit, especially in the early stage of tariff implementation, this is not problematic inflation that should be managed by the Fed's restrictive policy. Think of the economy in simple terms of supply and demand. If it is a true supply issue, like when OPEC cut production in the 1970s, then there can be problematic inflation. More recent and relevant, if demand goes unchecked, like when the government dropped $6-10 trillion (depending on your measure) of virtually free money on the economy during and post Covid, then problematic inflation can occur. In these cases, slowing the economy with restrictive monetary policy, like the Fed raising or keeping interest rates high, is the correct response.

Tariffs are not targeting supply or demand. Tariffs are taxes. If anything, higher taxes slow the economy. If higher taxes were levied on income, nobody would think that is inflationary. This tax is levied on imports to generate income for the government to help with deficits and to make our companies more competitive in a world where other governments have been subsidizing and protecting their industries. So, I would argue that even though prices may increase later this year, restrictive policy is not the antidote.

Indeed, tariffs have not led to increased inflation at all thus far. As retaliatory tariffs are implemented and inventories are restored, an uptick later this year is likely, but I am expecting it to be far less than what people were worried about earlier this year. After Liberation Day, people were throwing around numbers like 4% inflation or more due to tariffs, but those levels seem unlikely. As we stand today, CPI inflation readings are at 2.7%, and the Personal Consumption Expenditures (PCE) Price Index (i.e., the favorite inflation measure of the Fed) is at 2.1%.

If anything, tariffs should ultimately be a headwind for the economy because prices are likely to be slightly higher without an increase in demand. In fact, there are signs of decreased demand from both businesses and consumers. Real domestic final sales declined to 1.3% in the second quarter from 1.5% in the first quarter. Consumer spending, which grew at a 4.0% rate in Q4 of last year, slowed to a 0.5% rate in the first quarter.

Which brings us to the Fed. With the Fed Funds short-term rate at 4.25%, most economists and Fed members conclude that policy is set well above the neutral rate (a rate that is neither stimulative nor restrictive). There is plenty of room for the Fed to lower rates a bit to spur growth and influence long-term bond yields lower to help clear the real estate market and allow for refinancings. The number one mandate of the Fed is to fight inflation, and Powell has expressed a desire to wait until later this year to see if tariff policy ultimately leads to inflation or not. The number two mandate is to maintain full employment. If payrolls continue to weaken in the later part of this year, then the Fed may have to start cutting more aggressively than many are predicting at this point.

Judging from recent data, it seems like the Fed could potentially be getting behind. If economic data continues to weaken, then there will be more criticism to come, and maybe it will come from more places than just the White House talking daily about who will replace Powell when his term is up next year. For the record, I feel that it is absolutely imperative that the Fed be completely independent and not influenced by politics, and that President Trump is not doing the markets any favors by floating the idea of replacing Powell. That said, one can see how restrictive Fed policy is hindering Trump's policy design.

There are two main concerns we are focusing on. On the one hand, rising bond yields would be bad for stocks. The 10-year Treasury yield, currently at 4.4%, becomes a real problem if it approaches the 5% level. Combined with a declining dollar, this would mark true concern for deficit spending and fiscal policy. Tariff income and economic growth would help with this. However, if the economy slows from here then Trump's policies could be undermined, causing further policy shifts that create even more uncertainty, which could lead to even less demand, and Fed rate cuts would help here.

For the time being, the stock market continues to levitate. Perhaps it is confidence that Trump will continue to alter policy to support stocks if need be. Maybe it is simply the reasons cited above – there has yet to be a resurgence in inflation and expectations that the Fed is likely to change policy and cut rates supporting the economy and stock market. Time will tell, but the Fed should lower rates soon.

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