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THE INFLATION "BUZZ" AND THE EFFECTS ON FINANCIAL INSTITUTIONS

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What is all the buzz about inflation? Everywhere you turn, the headlines convey that inflation is looming on the horizon. From economists down to everyday investors, society is becoming concerned about the effects of inflation. What is inflation? In the simplest form, it is the decline of purchasing power due to an increase in the price of goods and services over a period. Financial institutions are tasked with managing interest rates that are associated with lending and borrowing throughout the various economic cycles. A major concern for financial institutions, regarding inflation, is the interest rate risk stemming from duration mismatch.

Early into the pandemic, the Federal Government and Federal Reserve took several steps to combat the virus and shield the economy. The Federal, State and Local Governments enacted lockdowns to slow the spread of the virus. Simultaneously, the Federal Reserve and Federal Government injected trillions of dollars of liquidity back into the economy in the form of direct stimulus payments, various credit facilities and by reducing short-term rates to zero. All of these measures were taken to combat the pandemic while providing support throughout the crisis. Now, as the number of COVID-19 cases continues to fall and more people are becoming vaccinated, state and federal restrictions will continue to be lifted, which will reopen the economy.

The Federal Reserve Committee is closely watching economic data as we enter the late stages of the pandemic to see whether we simply return to pre-pandemic levels or begin to overheat. The Consumer Price Index for April experienced the sharpest year-over-year increase since September 2008. In addition, the increase in the annual headline CPI rate was the fastest since September 2008, while the monthly gain in core inflation was the largest since 1981.

Chair Jerome Powell believes stronger inflation will be temporary over the next year, with underlying inflation dropping back to the 2 percent target next year. In addition, the Biden administration's beliefs coincide with Powell's that price inflation this year will be largely "transitory." The expectation is that inflation will return to the Fed target next year, as supply normalizes and consumer spending returns to normal. In addition, most of the Fed members are not projecting that the Fed will raise rates through at least 2023. For the end of 2023 there are eight members projecting at least one rate hike, and there are 11 members still staying at 0-.25 for the lower and upper bounds. The longer term is projecting rate hikes up to 2.5 percent, but it is unknown on exactly when.

Other economists do not subscribe to the Fed and Biden administration philosophy and are convinced the upward pressure on prices and wages will be sustained and underlying inflation will remain elevated. The thought is that by the time Fed officials respond, higher inflation will have become entrenched.

With the potential of higher or entrenched inflation, what should financial institutions do? Since not all rate-sensitive liabilities and assets have the same maturities, to effectively assess interest rate risk exposure requires a duration analysis to match hedge assets and liabilities.

About D. James Lutter

D. James (Jim) Lutter is the Senior Vice President of Trading and Operations at PMA Financial Network and PMA Securities where he oversees PMA Funding, a service of both companies that provides over 1,000 financial institutions with a broad array of cost effective funding alternatives. Mr. Lutter is a Registered Representative with PMA Securities and Investment Advisor Representative with PMA Asset Management. Mr. Lutter has the following FINRA licenses with PMA Securities, LLC: Series 7, 24, 50, 53, 63, 65 and 99.

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