

For The Fed, Failure To Curb Inflation Is Not An Option

Last year the main debate among economists was whether the inflation upsurge that suddenly gripped the nation was transitory or lasting. Most, including policymakers at the Federal Reserve, blamed transient forces related to the pandemic, which they believed would fade as health conditions improved. That view, of course, has since been debunked, and the Fed openly admits it waited too long to start the anti-inflation campaign that is now in full swing. At its last policy meeting on June 16, the Fed hiked short-term rates by three-quarters of a percentage point, the steepest one-off increase at a meeting since 1994 and signaled that several more increases were on the way in coming months.

More recently, the debate has shifted. Now the question is whether the Fed can tame inflation without causing a recession, i.e., steer the economy onto a soft landing. Most economists believe a recession is inevitable. One reason: the Fed has never successfully brought down inflation when it exceeded 5 percent without sending the economy into a downturn. By just about any measure, inflation is running well above that threshold. The Consumer Price Index in May clocked in at 8.6 percent over the past year, and even the Fed's preferred inflation gauge – the personal consumption deflator – increased by 6.3 percent in April from a year ago.

To be fair, the Fed's misreading of inflation last year was not entirely its fault. There was every reason to believe that in a post-pandemic world price pressures would ease as people resumed normal purchasing habits, spending more on services and less on goods that had spearheaded the inflation spiral because of torrid demand from home-bound consumers forced to stay indoors for health reasons or remote work. Nor could the Fed predict supply shortages that were amplified by the war in Ukraine and new waves of Covid that caused factory shutdowns in China. But the Fed also underestimated the purchasing firepower in the hands of consumers, stoked by more than \$2 trillion in excess savings accumulated during the pandemic from unspent funds and trillions of dollars of government stimulus payments. The Fed still believes that it can short-circuit that firepower and rein in the inflation genie without causing a recession, but it understandably admits the path to success has gotten considerably narrower

Is A Recession Inevitable?

As noted, history is not on the side of the Fed in avoiding a recession. It is hoping to replicate the experience in 1994-95 when rate hikes it implemented kept inflation under control without choking off growth. But its goal then was to prevent inflation from breaking out of the low 2-3 percent range it had been locked in over

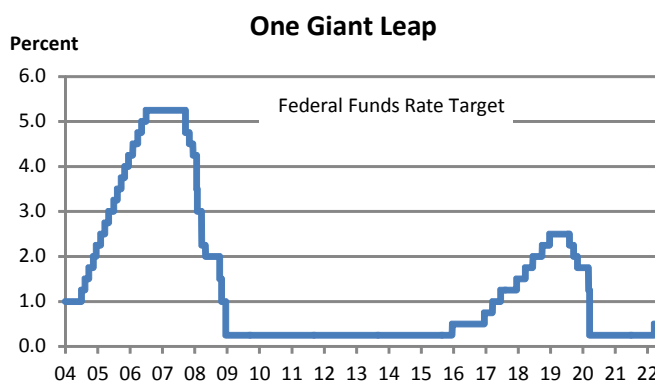
the previous decade. It's much more difficult to bring inflation down from sky-high levels that is underpinned by a sizeable excess of demand over supply. The challenge is to determine how much demand destruction is needed to wring out that excess and how much tightening is needed to do the job.

Keep in mind that interest rates are a blunt instrument in the Fed's toolkit. Not only do they have unpredictable effects on demand, their impact is felt with a lag. That's why the Fed tends to raise rates in small increments during tightening cycles, aiming to monitor effects along the way and change course if warranted by unfolding events. During the last tightening cycle, from 2016-2018, it raised rates 9 times in quarter-point increments to stave off inflation as the economy moved towards full employment. It stopped tightening when financial markets rebelled, and signs of weakness emerged. That flexibility to pause kept the economy afloat until the Pandemic sent it into a tailspin in early 2020.

But the Fed does not have the luxury of watchful waiting now as the inflation surge is already coursing through the economy. Importantly, unlike previous tightening episodes, inflation expectations are starting to creep up. As much as anything, the Fed knows that once expectations of higher prices gain traction, inflation becomes more deeply entrenched and more difficult to rein in. The response, therefore, needs to be swift and the message sent to households clear that the Fed will do anything in its power to restore price stability. The more successful the Fed is in retaining its inflation-fighting credibility, the easier it will be to prevent inflation expectations from getting out of hand.

Tipping Point

In the weeks leading up to the Fed's June 15-16 policy



meeting, most thought that officials would increase short-term rates by half-percentage point, matching the increase taken at the previous meeting in May. The fact that it turned even more aggressive—hiking by three-quarters of a percentage point to a range of 1.5%-1.75%—indicates that inflation concerns had taken a big leap upward.

The tipping point prompting the Fed's last-minute decision to go bolder arose from two key indicators in the week before the meeting. Most prominently was the consumer price report that revealed a bigger increase in headline inflation than expected, with the CPI leaping to 8.6 percent in May from a year ago, up from 8.3 percent in April. It was widely thought that inflation had reached a peak at 8.5 percent in March and would continue to moderate as it had in April; instead, it reaccelerated. The second disturbing report, perhaps even more so, was the University of Michigan reading on consumer inflation expectations over the next five years. After holding mostly at 3 percent or less for the past 25 years, the survey in early June revealed a leap to 3.3 percent, the highest since 1994.

Not coincidentally, that was the year the Fed last hiked its lending rate by three-quarters of a percentage point. But inflation then was running at around 3 percent and was in the midst of a decade long retreat; what's more, inflation expectations were declining. Now inflation is nearly three times as high and expectations are on the rise, a lethal combination that is understandably amplifying the Fed's angst that it is falling further behind the inflation curve.

Failure Is Not An Option

Unsurprisingly, the aggressive pivot by the Fed is roiling the financial markets. Through the middle of June, the stock market turned in its worst performance to start a year since the early 1960s and bond yields have soared. Mortgage rates, which are linked to the 10-year Treasury yield, has leaped to nearly 6 percent from 3 percent at the start of the year. The startling increase is impacting the housing market, sending sales into a nosedive, and making homeownership less affordable for a growing swath of the population.

Unlike the tail-end of the 2018 tightening cycle, the Fed is not overly concerned about the stock market swoon; indeed, it may even appreciate the helping hand that the wealth destruction from stock losses provides in curbing demand. Likewise the surge in market interest rates, which has been much steeper than the rate hikes imposed by the Fed, is doing some of the Fed's dirty work as the more it curbs activity the less the Fed needs to raise interest rates.

That said, the aggressive and front-loaded policy tightening is far from over. The Fed has a dual mandate of achieving full employment and low and stable inflation of around 2%. Given that the employment mandate has been met – the unemployment rate stands at a historically low 3.6 percent – but inflation continues to massively overshoot its 2% target, the Fed is hyper-focused on reducing inflation. While Chairman Powell is aware that tightening policy too quickly and too much could tip the economy into recession, he has asserted that “the worst mistake we could make would be to fail” to restore inflation to its 2% target, “which is not an option.”

How Far Will It Go?

At his Congressional testimony on June 21, Chair Powell reiterated that sentiment even more forcibly, admitting that the interest-rate hikes could send the economy into a recession, but it's an outcome he is willing to risk to rein in inflation. That's surely not what the administration wants to hear, but neither does it want its poll

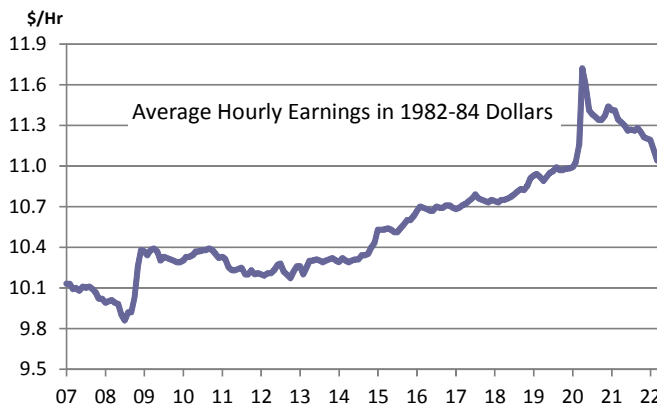
numbers continue to sink because of rampant inflation. In survey after survey, households steadfastly proclaim that inflation is their top worry. Indeed, a remarkable proportion of respondents believe that the economy is already in a recession, despite the solid growth in jobs, rising wages and low unemployment.

While recession fears amid a robust job market seem counterintuitive, it makes sense to workers who see their wages eroded by inflation. In inflation-adjusted dollars, average hourly earnings are no higher now than they were two years ago. True, lower-paid workers have received faster wage increases than higher-paid workers over the past year, although they too have not kept up with inflation. Importantly, as the Fed's rate-hiking campaign continues and its growth-dampening influence grows, the lower-paid workers will be the first to be laid off.

From our lens, there is still a reasonable chance that the Fed can pull off the elusive soft landing, but the odds of a recession within the next year have now risen. The rate hikes being considered by the end of this year alone—landing the Fed's prime lending rate above 3%—would be steeper than the increases seen during the entire 10-year expansion following the financial crisis. Signs of distress are already emerging. The housing market, as noted, was the first to buckle, but retail sales slipped in May, industrial production was weak and layoffs – while low – are creeping up.

These weakening signs point to slowing growth in coming months, but they do not portend a recession this year. For one, the job market is still going strong and businesses are bidding for scarce workers, driving up wages. For another, household and business balance sheets are in good shape. Only a small fraction of the savings accumulated during the pandemic has been spent, and homeowners have built up a formidable cushion of housing equity, thanks to booming property values. These positive influences give the Fed the flexibility to keep applying the brakes until demand is brought back into alignment with supply. A key risk, however, is that supply remains depressed by external forces, including the war in Ukraine and Covid-related business lockdowns, which would require a greater amount of demand destruction to restore a balance than otherwise. The worst-case scenario facing the Fed is that it weakens demand, and growth, even as supply restraints keep inflation elevated. That, in turn, is a recipe for the dreaded “stagflation” reminiscent of the 1970s, which would present policymakers with a much more complex set of challenges than they are dealing with now.

Real Earnings Falling Behind



KEY ECONOMIC AND FINANCIAL INDICATORS

FINANCIAL INDICATORS*

	<u>May</u>	<u>April</u>	<u>March</u>	<u>February</u>	<u>January</u>	<u>December</u>	<u>November</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
Prime Rate	3.94	3.50	3.37	3.25	3.25	3.25	3.25	3.94	3.25
3-Month Treasury Bill Rate	0.98	0.76	0.44	0.33	0.15	0.06	0.05	0.98	0.04
5-Year Treasury Note Rate	2.87	2.78	2.11	1.81	1.54	1.23	1.20	2.87	0.76
10-Year Treasury Note Rate	2.90	2.75	2.13	1.93	1.76	1.47	1.56	2.90	1.28
30-Year Treasury Bond Rate	3.07	2.81	2.41	2.25	2.10	1.85	1.94	3.07	1.85
Tax-Exempt Bond Yield	3.24	3.03	2.57	2.46	2.24	2.10	2.10	3.24	2.01
Corporate Bond Yield (AAA)	4.13	3.76	3.43	3.25	2.93	2.65	2.62	4.13	2.53
Conventional 30-Year Mortgage Rate	5.23	4.98	4.17	3.76	3.45	3.10	3.07	5.23	2.84
Dow Jones Industrial average	32379	34315	34030	34648	35456	35641	35849	35849	32379
S&P 500 Index	4040	4391	4391	4436	4574	4675	4667	4675	4040
Dividend Yield (S&P)	1.56	1.54	1.40	1.46	1.39	1.34	1.36	1.56	1.33
P/E Ratio (S&P)	20.7	20.7	22.8	22.4	23.1	24.6	25.0	27.0	20.7
Dollar Exchange Rate (vs. Major Currencies)	119.8	117.3	116.4	115.0	115.1	115.8	115.4	119.8	111.9

* Monthly Averages

ECONOMIC INDICATORS

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								<u>High</u>	<u>Low</u>
Housing Starts (In Thousands)	1549	1810	1716	1777	1666	1768	1706	1810	1549
New Home Sales (Thousands of Units)		591	709	792	831	839	756	839	591
New Home Prices (Thousands of Dollars)		451	435	437	431	410	430	451	375
Retail Sales (% Change Year Ago)	8.1	7.8	7.1	17.7	13.7	16.8	18.6	18.9	7.1
Industrial Production (% Change Year Ago)	5.8	6.3	5.0	7.4	3.2	3.5	5.0	10.2	3.2
Operating Rate (% of Capacity)	79.0	78.9	77.9	77.6	76.9	76.3	76.6	79.0	75.2
Inventory Sales Ratio (Months)		1.29	1.28	1.27	1.27	1.29	1.26	1.29	1.26
Real Gross Domestic Product (Annual % Change)			-1.5			7.0		7.0	-1.5
Unemployment Rate (Percent)	3.6	3.6	3.6	3.8	4.0	3.9	4.2	5.9	3.6
Payroll Employment (Change in Thousands)	390	436	398	714	504	588	647	714	390
Hourly Earnings (% Change Year Ago)	5.2	5.5	5.6	5.2	5.4	4.9	5.3	5.6	4.0
Personal Income (% Change Year Ago)		2.6	-11.4	6.6	-1.7	8.0	8.2	8.2	-11.4
Savings Rate (Percent of Disposable Income)		4.4	5.0	5.9	6.0	8.7	7.6	10.5	4.4
Consumer Credit (Change in Blns. Of Dollars)		38.1	47.3	34.1	15.3	22.9	32.0	47.3	15.3
Consumer Prices (% Change Year Ago)	8.6	8.3	8.5	7.9	7.5	7.0	6.8	8.6	5.3
CPI Less Food & Energy (% Change Year Ago)	6.0	6.2	6.5	6.4	6.0	5.5	4.9	6.5	4.0
Wholesale Prices (% Change Year Ago)	10.7	10.9	11.6	10.5	10.2	10.2	9.9	11.6	7.5

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