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ECONOMIC TALKING POINTS

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Chapter Two: Interest Rate Lift off or Run Down the Balance Sheet?

Now that the Fed is prepared to double the pace of tapering QE asset purchases, from $15 billion to $30 billion a month, the debate will now intensify on what their next step will (and should) be in cooling inflation.

With consumer prices escalating at the quickest pace in 40 years and the more forward-looking producer prices racing ahead faster than ever, we can expect the Fed to raise interest rates one or two times in 2022. The dot plot by the FOMC hints of even more aggressive action. But anything more than two rates hikes increases the risk of pressuring household and corporate finances given the high level of debt each carries. And if there's one thing you want to avoid during a pandemic and when the country is in the midst of a highly contentious midterm Congressional election is to cause more harm at such a delicate time.

Our own forecast calls for two rate increases in 2022, followed by a gently upward slope of another four hikes in 2023.

But all these interest rate projection should come with a loud warning.

Too often these days, forecasts of economic activity and inflation are based on a straightforward linear view of how current conditions would play out in the year ahead. But if there's one big lesson we should have learned since the onset of the pandemic it is that our economic models are utterly incapable of working through this historic and complex rush of exogenous shocks (e.g., Covid variants, supply chain knots, energy shortages). Assessing the path of the economy in strictly linear terms has become, to say the least, hazardous. There are just too many unusual and unfamiliar moving parts. Think of it this way: The economy these days more closely resembles a game of pool. Every time someone takes a shot, it resets the entire table! Suddenly everything needs to be reevaluated.

Case in point: six months ago, the FOMC's Summary of Economic Projections saw real GDP growth this year to be 7% and (PCE) inflation settle at 3.4%.

Well, scratch that!

With today's Fed meeting, their forecast for real growth in 2021 was lowered to 5.5% and they boosted inflation to 5.3%. Other significant revisions were made for 2022 and 2023.

The point is that in the current environment, there is tremendous uncertainty how inflation will behave in 2022 and 2023.

Some analysts see it as an out of control wildfire that's rapidly spreading across economic sectors. Their solution is to hit the monetary brakes hard.

Others, however, seem confident that inflation's vertical take off this year cannot be sustained because in a modern market economy, the solution to higher prices is…higher prices. That is, consumers will inevitably seek out cheaper alternative goods --- or choose to curb spending altogether (AKA demand destruction). There is also a limit to how much companies can pass rising costs on to customers. Perhaps fearful of losing market share, firms will be more inclined to accept slightly thinner margins. They know well that once you lose market share, it is hellishly costly and time consuming to win customers back.

So let's transition to what we hope the Fed will consider for 2022. A more palatable strategy in this unique moment in economic history is to FIRST proceed with running down the Fed's $8.7 trillion balance sheet, which has doubled in size since the onset of the pandemic.

A reduction in the balance sheet that focuses on unloading longer dated issues (that is, not replacing them as debt mature) should steepen the yield curve and help cool some overheated areas of the economy, like housing and excess corporate leveraging. The cost of capital will also be less distorted because the price of debt would then be determined largely by investors and their perceptions of future inflation and interest rates. Let's get real here --- can anyone justify a 30-year treasury bond at 1.83% when the odds of a recession the next five years are less than 20%?

A runoff in the Fed's balance sheet would also have a milder effect on Americans and be less politically volatile in the aftermath of global headlines of the world's most important central bank hiking rates for the first time since 2018.

Powell today did not commit himself to any timetable on raising interest rates. But there is a solid argument to be made that perhaps a better strategy would be to first gently wind down the Fed's balance sheet and hold off driving up short-term rates until we get more clarity on the path of the pandemic and with fiscal policy now less stimulative.

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United States

	I 2020	II 2020	III 2020	IV 2020	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022	I 2023	II 2023	III 2023	IV 2023
Real Gross Domestic Product (GDP):																
%	-5.0	--31.4	33.4	4.3	6.3	6.7	2.1	6.6	3.1	3.4	3.1	2.9	1.8	2.7	2.5	2.6
Personal Consumption Expenditures:																
PCE %	-6.9	-33.2	41.0	2.3	11.4	12.0	1.7	7.1	2.6	4.2	3.7	2.9	1.5	2.9	2.8	2.7
Inflation, end of period, year-over-year:																
CPI %	1.5	0.6	1.4	1.4	2.6	5.3	5.4	6.9	6.8	6.1	5.5	3.8	3.3	2.8	2.6	2.3
Unemployment Rate (end of period):																
%	4.4	11.1	7.8	6.7	6.0	5.9	4.8	4.1	4.1	4.2	3.9	3.8	3.9	3.7	3.6	3.5
Non-farm Payrolls, monthly avg. thousand:																
	-303	-4,427	1,322	213	513	615	651	465	455	625	865	640	385	510	495	480
Treasury 10-yr Note Yield % (end of period):																
	0.63	0.65	0.68	0.91	1.75	1.44	1.52	1.48	1.60	1.65	1.75	2.05	2.10	2.10	2.26	2.35
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.63	0.88	1.13	1.38	1.63

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
US	2.6	1.6	2.2	1.8	2.5	3.1	1.7	2.3	3.0	2.2	-3.5	5.4	3.3	2.6
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-6.7	4.0	3.5	2.2
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.5	-9.8	5.9	4.8	2.9
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	2.2	0.3	0.7	-4.8	2.4	2.8	2.2
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.0	1.6	-5.3	5.2	4.7	2.7
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.8	-8.2	6.9	7.3	6.7
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.1	2.3	6.6	5.9	5.6
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.1	-4.4	4.9	2.1	2.4
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.1	-0.1	-8.4	5.9	2.8	2.7
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	-1.1	4.8	3.1	2.3
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	-2.9	3.8	2.9	2.4
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.9	--3.8	5.6	4.8	3.6

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