

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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Prepare For The Tiptoe Taper

A raging debate has erupted on when the Federal Reserve should begin to tighten monetary policy. At the core of this argument are two profoundly different views how serious a threat inflation poses.

One group chaffs at how the Fed's head is in the sand. They believe the massive fiscal and monetary stimulus enjoyed by households and businesses the last four months will cause the economy to overheat and significantly ramp up inflation, perhaps to levels not seen since the 1980s. To avoid such a calamity, the Fed must act quickly to raise short-term rates and shut down asset purchases.

Failure to do so now, they warn, would put the Fed woefully behind the inflation curve. After that, any effort to catch-up would require raising interest rates faster and higher than desired. And, as we have seen from past interest rate cycles, if you yank borrowing costs up too much, the economy struggles and you end up with recession. Bottom line: The Fed must begin to tighten monetary policy now or risk runaway inflation and an economic downturn later.

Not so fast, the other side counters. The Fed is right to be patient.

It's true we will see inflation pop in the months ahead. March core inflation (PCE prices ex.food and energy) rose 1.8% over the past year, the most since February 2020. Trust me, it will climb even faster in the near term because of the base effects, where the numbers are being compared to the very weak inflation prints seen at the start of the pandemic. In addition, we have seen prices for lumber, semiconductors, copper, steel, aluminum and a host of other commodities climb recently.

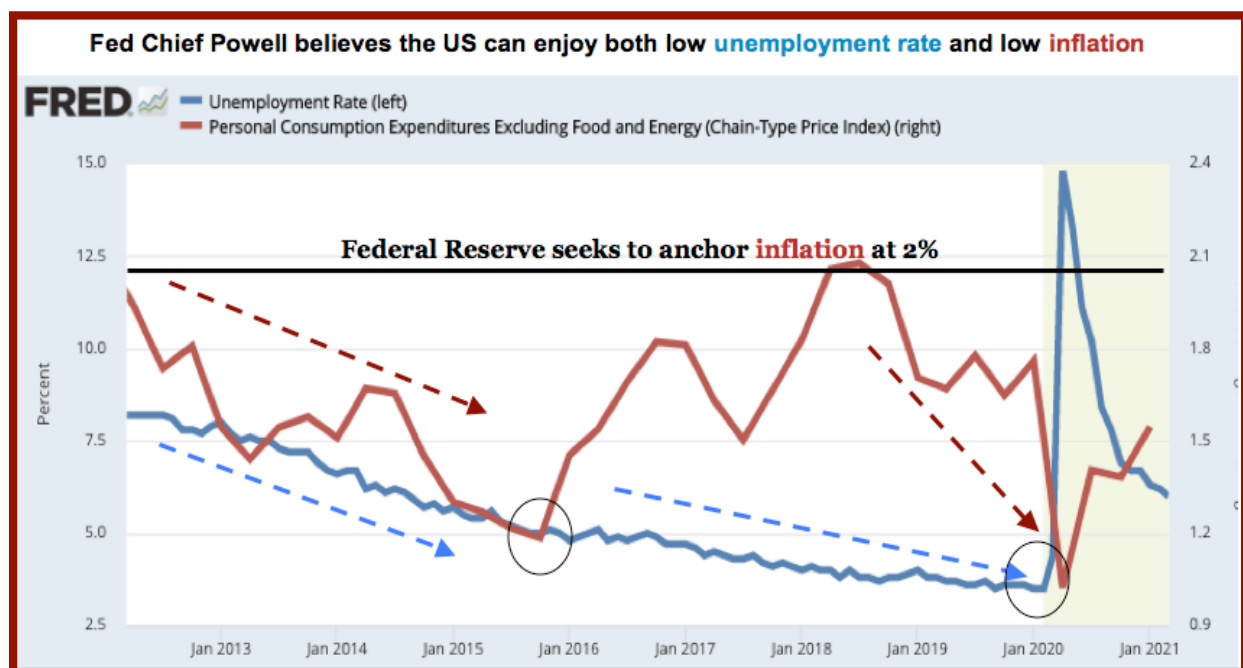
But these hikes are easily explainable and, more importantly, will not last. The world economy is re-awakening from its comatose state due the Covid-19 pandemic. As more people get vaccinated in the US and with businesses and cities opening up again, aggregate demand for goods and services will bounce back faster than the ability of factories and retailers to keep up *in the short run*.

The pandemic has severely disrupted global supply chains and produced bottlenecks in the delivery of many critical products. Further aggravating matters is that many corporate managers were pursuing “just-in-time” inventory strategies and that left lots of factories and retailers high and dry. But, again, this large imbalance between aggregate demand and supply will ease the next two to three quarters. The Fed therefore should remain patient and not rush to kick up rates, since that would risk snuffing out an economy on the rebound.

Let’s delve a little deeper on why any spike in inflation will be short-lived? This assessment is based on three central factors.

The first is straightforward. Supply chain networks are gummed up at the moment, but they should clear in the next few months. We are already seeing an easing in the backlog of container ships being unloaded at the ports of Los Angeles and Long Beach, the nation’s largest gateway for imported goods. The average wait for berth space is now around 7 days, down from nearly three weeks earlier this year. Moreover, in the last 12 months trucking companies hired more than 55,000 additional drivers to speed up the delivery of products to manufacturers, wholesalers and retailers.

The second dynamic has longer term implications. The labor market has undergone structural changes in the last few years and one fascinating outcome is that it possesses more slack than many economists thought.



A few years ago economists widely believed that when the unemployment rate dips below 6%, it would fire up wages. In fact, many economists *still* view 6% as the lowest sustainable level joblessness can go without triggering a corrosive wage-price spiral.

But then something changed. Since the 1990s, we began to see inflation and unemployment fall in tandem. When the national jobless rate plummeted to 3.5% in February 2020, the lowest in 52 years, the Fed's preferred inflation gauge (core PCE

price index) still remained below 2%. This suggested that labor market conditions were much more expansive than we thought.

For example, you may recall how employers were complaining about the difficulty in finding suitable workers late 2019 and early 2020. Their solution was to reach out to the fringes of the labor force. The demographic segment that enjoyed the biggest decline in unemployment just before the pandemic were those who never even completed high school. Other segments of the labor force, like African Americans and Hispanics, also saw job opportunities dramatically improve.

If history is a guide, we should still be able to bring the unemployment rate below its current 6% level, perhaps back to 3.5% or even less without torching wage inflation. It is therefore appropriate for the Fed to allow joblessness to fall to half its current level and then patiently monitor inflation pressures in the interim.

The third dynamic is arguably the most difficult to prove. All we have is our own intuition that nonfarm productivity has improved more than the economic data suggests. Some of us are still haunted by the words of Nobel laureate Robert Solow when he rightly said “you can see the computer age everywhere but in the productivity statistics.” But let’s face, it has never been easy to compute productivity in a predominantly service oriented economy. So we have to realistic. It simply defies common sense that AI, robotics, cloud computing, e-Commerce, the Internet of Things, drones, 3-D printing are having only a negligible impact on improving productivity. To dismiss their impact is intensely counter-intuitive.

The productivity statistics may not reveal much but there are two key indicators that indirectly suggest all this technology is having a large impact on boosting productivity --- and that is the way it has kept inflation at bay up to now and the impressive growth in corporate profits.

So when forecasting inflation, one has to make a leap of faith — a safe one I believe — that the methodology to calculate productivity is flawed. Our economy has become much more efficient with the ubiquitous use of new technologies and this will continue to help dampen inflationary pressures.

So what should the Fed do at this stage? Frankly, nothing major at this time. But as the economy regains its footing, Powell will face one truly vexing issue later this year: How do you reduce asset purchases without causing major turbulence in the bond market? Such instability is the very last thing Powell wants to risk given his re-appointment to be Fed Chair comes up in February of 2022.

Thus Powell’s next big brain storming session is for the Fed to craft a calm, comforting message that acknowledges the economy’s progress and informs financial markets ever so softly and reassuringly (think Mister Rogers here...) that the time has come for the Fed to scale back purchases of treasuries and agency securities.

It’s the tiptoe taper the Fed needs to think about next.

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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	6.4	8.7	6.6	5.9	3.8	4.9	5.5	4.2	2.8	3.5	3.1	2.9
Personal Consumption Expenditures:																
PCE %	-6.9	-33.2	41.0	2.3	10.7	11.3	6.5	6.0	3.4	5.2	4.2	3.6	3.1	4.1	2.8	3.5
Inflation, end of period, year-over-year:																
CPI %	1.5	0.6	1.4	1.4	2.6	2.7	2.5	2.5	2.4	2.4	2.3	2.2	2.5	2.6	2.6	2.7
Unemployment Rate (end of period):																
%	4.4	11.1	7.8	6.7	6.0	5.8	5.7	5.6	5.4	5.5	5.6	5.4	5.4	4.9	4.4	4.1
Non-farm Payrolls, monthly avg. thousand:																
	-303	-4,427	1,322	213	539	555	510	620	424	325	265	240	185	225	235	250
Treasury 10-yr Note Yield % (end of period):																
	0.63	0.65	0.68	0.91	1.75	1.68	1.65	1.79	1.77	2.05	2.00	1.94	1.90	2.05	2.00	2.10
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	0.13	0.13	0.13	0.38	0.88	1.13

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	7.2	4.6	3.1
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-6.8	3.3	2.5	2.0
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.5	-9.9	4.4	4.6	3.1
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	-5.1	5.4	3.4	2.9
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.8	-8.2	9.1	6.4	5.7
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.1	2.3	6.9	5.7	5.6
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.1	-4.1	2.9	2.7	2.4
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.1	-0.1	-8.3	3.3	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	2.5	3.0	2.7
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	-3.1	2.4	3.3	2.0
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.9	-4.2	4.4	4.2	3.9