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ECONOMIC TALKING POINTS

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January Inflation: What Should the Fed Do?
Go for 50 bp Hike in March.

Brace yourself: January's CPI release tomorrow is certain to set off a firestorm debate in the US and around the world on how the Federal Reserve should respond.

The latest projections show annual inflation rose anywhere from 7.1% to as high as 7.7% last month. Most agree it will be above December's rate of 7.0%. On the other hand, there is always the more gratifying, if remote, possibility that inflation reversed course and fell below 7%! If so, that would truly be a major miss among experts --- and come on the heels of another colossal miss last week with January's jobs report. Our own assessment is that CPI inched up to 7.2% over the last 12 months.

But we can say with certainty that the drum roll signaling a regime change in monetary policy will at long last reach its crescendo next month. The Fed is about to shift course and raise short-term rates.

Two questions now loom large.

First, given the combination of an exceptionally robust job market and the highest inflation rate in 40 years, will the Open Market Committee choose to proceed with a 50-basis points hike, or something more timorous?

Our expectation (and hope) is the Fed will commence with a 50 bp increase, which would lift the midpoint fed funds rate to, let's face it, a hardly mammoth 0.63%. Such a leap may initially stun financial markets. But it is absurd to characterize a half-point increase as a "shock and awe" blast by the Fed, not when inflation is running more than ten times that pace--- and not, let me add, when the current fed funds rate is still hugging zero! Frankly, anything less than 50 bp would only provide more fuel to Powell critics that the Fed has lost all credibility as the nation's guardian against rampant inflation!

Second, and actually far more interesting, is what happens after the March meeting? How many more times will the Fed kick rates up this year?

There's a wide consensus they will lift the fed funds rate by 25 bp in each of the six subsequent meetings in 2022. But this is where we part ways.

Putting monetary tightening on autopilot is not just reckless, it shows a lack of understanding how fluid the forces impacting inflation really are. Let's review a few:

1. Aggregate demand is already moderating. The economy this year will likely grow at about half last year's pace, slowing from 5.7% to about 3%. You can be sure some will argue that even at a 3% pace, growth would remain significantly above the economy's non-inflationary speed limit of around 2%, and thus continue to overheat.

But that is antiquated thinking. First, a change in monetary policy impacts the economy 12 to 18 months down, which is why the Fed has to be more forward-looking. By 2023, we're projecting economic growth will downshift toward a 2% handle.

Second, technology and globalization have greatly muted the relationship between growth and inflation. In the nearly 20 years prior to the pandemic, there have been many instances annual GDP growth shot up above 3%, yet core PCE prices, the Fed's preferred inflation metric, never exceeded 2.5%.

Third, if we assume the primary cause of the latest inflationary spiral is due to global supply chains seizing up and escalating wages, then it follows that an improvement in the flow of goods in the US and an increase in the supply of labor would together help cool price pressures.

It turns out that process is now well underway. Foreign goods entering the US rose in each of the last five months and jumped to a record $259.7 billion in December. These imports help replenish depleted stockrooms and back lots. Retail inventories, for example, increased 4.4% in December to $643.8 billion, the highest since the onset of the pandemic.

And more supplies are on the way. Wholesalers filled up their shelves with goods in December, reaching in value a record $790.8 billion in December, up nearly 20% from a year ago. These items covered a wide spectrum of products --- capital goods, consumer products and motor vehicles. This massive rebuild of business inventories contributed more than 50% of the economy's 6.9% GDP growth rate in the final three months of the year.

But let's not stop there. As of January 2022, we have a record 1.55 million people employed in the trucking industry to help transport these good, and another 1.73 million workers in warehouse and storage facilities to collect and route these goods.

These are deflationary forces at work. Even the Federal Reserve Bank of New York and the Institute for Supply Management have observed an improvement in supply chain activity. While that's not the case with every industry, such as semiconductors, there is measurable relief materializing across other sectors of the economy.

What of wage inflation? They continue to accelerate based on data from the Employment Cost Index and average hourly pay. But pay is a lagging indicator. Many of the unemployed who have been sitting on the sidelines last year are now re-entering the job market. Last month alone saw the size of the labor force surge by 1.4 million, the

biggest one-month increase since June 2020 when it bounced back from the Covid-linked collapse. As a result, the labor force participation rate and the employment-population ratio have now moved to their highest level since the onset of the pandemic. As the supply of labor increases, it will also tamp down wage pressures and we should see initial evidence of that by midyear.

Our expectation is that the Fed will (and should) lift rates 50 basis points in March and perhaps add another 25 bp in May --- and then act only on a *pro re nata* basis.

• Has the end of quantitative easing in March decelerated economic activity?
• To what extent will quantitative tightening impact market rates, the cost of credit and the yield curve?
• Are supply chains networks operating more smoothly and with faster delivery times?
• Are more Americans rejoining the workforce now that (a) Washington is no longer sending out emergency checks to households, (b) consumer purchasing power has eroded due to inflation, and (c) with the personal savings rate on the decline?

Our forecast calls for inflation to peak by March or April at 7.3%, and then steadily decline to near 3% by the end of year. So a 50 basis point increase next month makes eminent sense, followed by a 25 bp rise in May. Both should help lessen criticism that the Fed has gravely fallen behind the inflation curve.

Beyond those two steps, however, the Fed should pause to see whether the powerful deflationary forces that were in effect prior to the pandemic are making a comeback. If so, it would remove the need to robotically hike at every FOMC meeting this year.

United States

	I 2021	II 2021	III 2021	IV 2021	I 2022	II 2022	III 2022	IV 2022	I 2023	II 2023	III 2023	IV 2023	I 2024	II 2024	III 2024	IV 2024
Real Gross Domestic Product (GDP):																
%	6.3	6.7	2.3	6.9	2.2	3.6	4.1	3.3	1.8	2.7	2.5	2.6	2.2	2.7	3.0	2.2
Personal Consumption Expenditures:																
PCE %	11.4	12.0	2.0	3.3	2.1	4.2	3.7	2.9	1.5	2.9	2.8	2.7	2.0	2.7	2.5	2.8
Inflation, end of period, year-over-year:																
CPI %	2.6	5.3	5.4	7.0	7.2	6.1	5.3	3.8	3.3	2.8	2.6	2.3	2.2	2.3	2.3	2.4
Unemployment Rate (end of period):																
%	6.0	5.9	4.7	3.9	3.9	3.9	3.8	3.9	3.7	3.6	3.5	3.7	3.6	3.6	3.6	3.5
Non-farm Payrolls, monthly avg. thousand:																
	513	615	651	365	455	625	665	640	385	510	495	410	275	310	315	325
Treasury 10-yr Note Yield % (end of period):																
	1.75	1.44	1.52	1.51	1.75	1.85	1.90	2.05	2.15	2.25	2.30	2.40	2.40	2.45	2.53	2.45
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.38	0.88	0.88	0.88	1.38	1.88	1.88	1.88	1.88	1.88	1.88	1.88

GDP Growth - Global Economy

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
US	2.6	1.6	2.2	1.8	2.3	2.7	1.7	2.3	2.9	2.3	-3.4	5.7	3.3	2.4	2.5
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-6.7	5.2	3.9	2.4	1.7
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.5	-9.8	5.7	4.6	2.5	2.0
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	1.7	0.6	-0.2	-4.5	2.0	2.8	2.2	1.4
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.0	1.6	-5.3	4.5	4.2	2.8	2.4
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.8	-7.5	7.8	7.0	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	8.1	4.9	5.2	5.4
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.1	-4.4	4.4	2.3	3.3	2.7
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.1	-0.1	-8.5	5.0	2.9	2.7	2.4
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	-1.1	4.3	3.1	2.6	2.7
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.5	1.2	-2.9	4.5	2.7	2.4	2.1
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.7	–3.4	5.4	4.4	3.4	3.2

Key Economic & Geopolitical Projections for 2022 & 2023

- Latest revision: February 9, 2022

PROBABILITY	U.S.
HIGH	Odds of recession from 2022 thru 2024 are about 20%, absent any major geopolitical shocks.
Moderate	Federal Reserve begins to raise fed funds rates in 1Q 2022. Expect 50 pb in March and 25 pb in May before pausing.
HIGH	CPI inflation drops to 3% range late 2022 as supply chains improve, wages stabilize and WTI oil slips to $70s bbl.
Moderate	Treasury 10-yr. yields to hover between 1.80% to 2.10% in 2022, and peaks at 2.55% in 2024.
HIGH	Covid-19 becomes an endemic. Low vaccination rates in Africa & parts of Asia remain breeding grounds for new variants.
Moderate	Congress to pass only parts of "Build, Back Better" plan by 3Q 2022, with no material changes in tax rates.
	FOREIGN
HIGH	Odds are 60% Russia will NOT launch a major invasion into Ukraine. Putin & Russian oligarchs worry costs will be too high.
HIGH	Beijing fortifies naval presence in SCS and ramps up threats against Taiwan.
HIGH	Biden orders greater US naval presence in SCS to defend International Law of the Sea and support regional allies.
HIGH	China's economy to decelerate due to shakeout in property market, broad deleveraging & fresh Covid outbreaks.
HIGH	A cyber World War is underway; likely to result in periodic disruptions to global financial networks and power grids.
HIGH	Iran secretly moves ahead to produce enough fissile material for a nuclear weapon. Israel readies pre-emptive action.
Moderate	Economies of US & Europe to steadily improve in 2022, but recoveries in Africa & Latin America to lag behind 1 - 2 years.

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