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ECONOMIC TALKING POINTS

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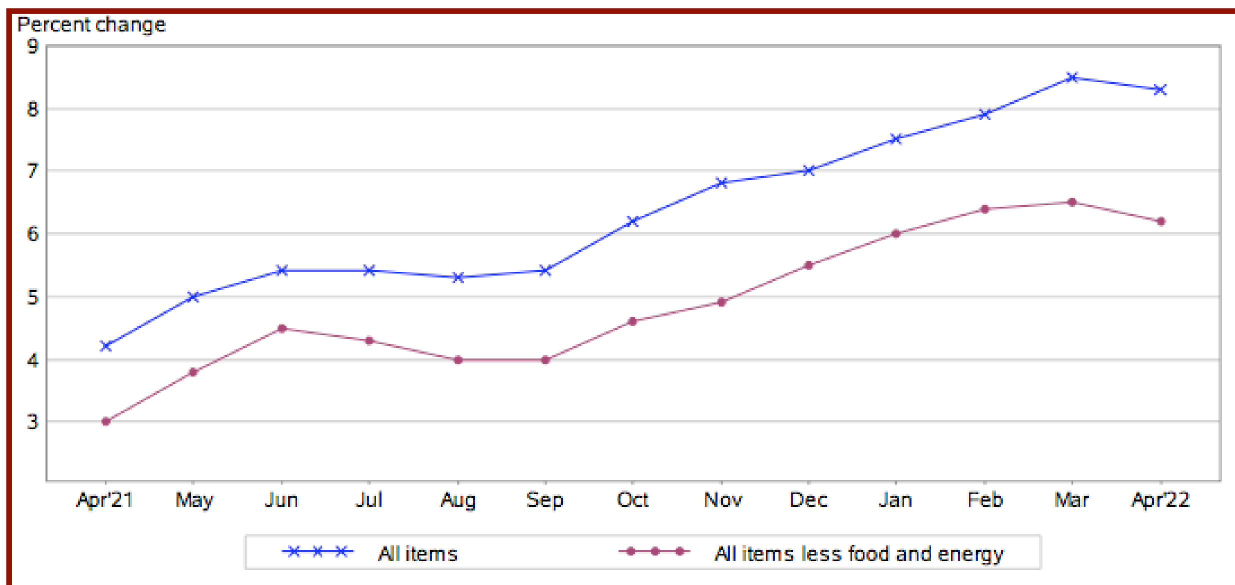
May 11, 2022

Inflation is at an inflection point. Will The Fed Still Charge Ahead with Higher Rates, Or Turn Less Aggressive?

We got fresh encouraging news on the inflation front. April's CPI slowed to 8.3% over the year, down from the 8.5% pace of March. If you remove the volatile food and energy components, core consumer prices decelerated to 6.2% in April, versus 6.4% the previous month.

And while some analysts will be troubled by the month-to-month increase in core CPI, which doubled from 0.3% in March to 0.6% in April, historically core CPI tends to follow the path of headline inflation by 2 to 6 months. In any event, core CPI has fallen in two of the last 3 months.

CPI and Core CPI: Annual % Change



So what might the Federal Reserve do with this relatively positive inflation report, and what still are the odds of recession?

There are two main lines of thought on how the Fed will proceed.

View 1: The latest slowdown in inflation will not deter Jerome Powell and the Open Market Committee from its current course of aggressively kicking up short-term interest rates. The Fed has been terribly late in recognizing how pernicious inflation has been and now must do whatever it needed to fulfill its mandate of price stability. Borrowing costs will thus continue to climb and very likely choke off economic activity and bring on a recession later this year or in 2023. It's an ugly scenario, this reasoning goes, but sadly that's the price to pay since the Fed erred too long thinking this inflation was to be a brief, transitory phenomenon.

View 2: This view may not appear much different than the one above --- except for one glaring difference. The worry about a recession is also real, but that's because the Fed is about to make a grotesque mistake by continuing to hit the monetary brakes hard. Instead, with inflation plateauing, Powell should reassess the Fed's strategy and act less aggressively. If they continue their relentless path to hammer consumer prices down to 2%, it would likely trigger an economic downturn. Let me parenthetically add, some members of the Administration are nervously eyeing the midterm elections and discreetly urging the Fed to act forcefully so as to bring down inflation more quickly.

So where this second view differs from the first is the concern the Fed will *needlessly* tighten more than is necessary and probably cause the economy to sink.

I am more in agreement with this second assessment. The endless charge that the *"Federal Reserve is way behind the inflation curve"* has grown tiresome, and I believe an exaggeration.

Yes, inflation has obviously surprised on the upside because the world just suffered through at least three freakish, "once-in-a lifetime" shocks --- all erupting within the span of about 24 months! There was the initial Covid-19 pandemic, which pulverized the global economy and froze global supply chains. Lay on top of that the war in Ukraine and how it has further driven up the cost of energy and food everywhere. And then we have China's zero-tolerance policy to quash local outbreaks of Covid. That harsh policy forced key Asian factories and ports to shut down, further aggravating supply chains.

The result: The Fed---like everyone else---was caught off guard on how to interpret and respond to these unique events. There is no economic model, no established framework, and no playbook on how Powell should have addressed the consequent jump in inflation under such bizarre circumstances. All one can say is that shocks historically disrupt economic activity on a temporarily basis--- and then recover in short order as the forces that shape inflation return to some semblance of equilibrium. That is precisely what I see is at work in the economy right now. The Fed should take notice of this corrective process and let it play out. Sharply higher interest rates would only disrupt it all.

Let me lay out a few examples of forces at work that are already cooling inflation pressures. Remember, both the CPI and the Fed's preferred inflation gauge, the

PCE price index, are moving in tandem to show that retail prices appear to have peaked. Both indicate inflation has begun to retreat.

1. Wage inflation is slowing. The job market has been the bright and shining star in the economy. Yet, it is rather startling to hear Powell utter last March how the labor market was now "tight to an unhealthy level" primarily because the demand for workers greatly exceeds the number of people presently unemployed.

To argue that strong employment trends has reached toxic levels sounds incredibly odd. Fed economists fear the labor shortage would persistently drive wages higher and ultimately lead to a destructive wage and price spiral. Yet we see evidence that wage growth has been easing. Average hourly earnings in April were up 5.46% over the year, down from its recent peak of 5.62% in March. Wages and salaries from the Personal Income report (the latest available) also showed pay growth slowing on a monthly and annual basis. Sure, the improvement has been small, but it should not be ignored. It is enough at least for the Fed to turn more cautious about future rate hikes.

2. Factory inventory levels are also being rebuilt and that should also temper inflation pressures. This week the government reported wholesale inventories increased more than expected in March and substantially revised up February's numbers as well. This suggests that supply chains woes are starting to ease, which helps reduce product scarcities. Wholesale inventories are now up 22% from year ago levels. It's another positive sign of adjustments taking place that will ultimately help bring retail prices down.

3. To offset the labor shortage and function more efficiently, companies have been dramatically ramping up capital investments. New orders to manufacturers for nondefense capital goods, excluding aircraft, the purest measure of business capital spending on the civilian use of machinery, computers, robotics and other equipment, has been on a tear. This is good news for the economy. Again, the private sector is adjusting. However, if the Fed is determined to drive borrowing costs to painful levels, it will severely disrupt these private sector efforts to function more productively and hamper efforts to safely bring inflation down.

4. Consumer will not remain undeterred by rising prices. Americans are already seeking out cheaper alternatives. Brand loyalty erodes during periods of painful inflation. People will alter their behavior and seek out less costly products and services. Let's not forget that online shopping still is the greatest deflationary force in modern history. With gasoline prices still high, consumers will continue to shop on line and compare prices, seek reviews and search for deals. Those retailers who prefer to maximize profits over market share, will quickly see an erosion of the latter. And once you lose market share, it is hellishly costly and time-consuming to get it back.

In summary, we are seeing an extremely dynamic economy at work where companies as well as consumers are taking steps that will continue to ease inflation pressures in the months ahead. The Fed should not rely on some outdated, pre-21st century model that would typically call for more heavy-handed intervention in the credit markets. If they continue to rely on that old playbook, inflation will certainly drop back -- but only because the economy had entered a recession and shut down.

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	-1.4	3.3	2.8	2.6	1.8	3.6	3.1	2.1	2.4	3.3	2.4	2.8
Personal Consumption Expenditures:																
PCE %	11.4	12.0	2.0	2.5	2.7	3.8	2.6	2.0	2.1	4.1	3.2	2.0	2.6	3.8	2.6	2.7
Inflation, end of period, year-over-year:																
CPI %	2.6	5.3	5.4	7.0	8.5	8.8	7.4	4.1	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	3.6	3.5	3.4	3.4	3.6	3.7	3.6	3.5	3.7	3.6	3.6	3.5
Non-farm Payrolls, monthly avg. thousand:																
	513	615	651	365	562	445	465	340	385	510	495	410	275	310	315	325
Treasury 10-yr Note Yield % (end of period):																
	1.75	1.44	1.52	1.51	2.32	2.80	2.70	2.55	2.55	2.70	2.70	2.60	2.65	2.61	2.72	2.70
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.38	1.13	1.63	2.13	2.38	2.38	2.38	2.38	2.38	2.38	2.38	2.38

GDP Growth - Global Economy - Year over Year

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	2.2	2.4	2.7
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	1.8	2.4	2.5
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.3	1.5	-9.8	7.5	3.3	2.4	2.3
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	1.7	0.6	-0.2	-4.5	1.7	2.0	2.2	1.9
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	3.0	2.9	2.6
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.8	4.8	-7.5	9.2	6.6	6.8	6.9
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.6	6.1	2.2	8.1	4.3	5.5	5.6
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.1	-3.9	4.5	1.6	2.2	2.6
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	1.9	2.6	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	4.7	3.8	2.7	2.9
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	-14.0	-5.0	2.1
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.7	--3.1	6.1	3.4	3.9	4.1

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