THE ECONOMIC OUTLOOK GROUP

475 Wall Street
PRINCETON, NEW JERSEY 08540 Tel: 609 - 529 - 1300
www.EconomicOutlookGroup.com

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist

August 5, 2022

A Perplexed Federal Reserve: As Interest Rates Climb, Hiring Accelerates

What's fascinating about July's strong employment numbers is that it highlights yet again our poor understanding of how the last three years have completely transformed the economy.

Since 2020, the global economy has been pounded by multiple once-in-a-lifetime shocks. The fallout from the pandemic, supply chain woes, Russia's war in Ukraine, Covid-related lockdowns in China, escalating tensions along the Taiwan Strait and South China Sea has forced a restructuring of the US economy. It has fundamentally changed how we work, play and conduct business.

Unfortunately, one major consequence of that is it has also made the macroeconomic models that forecasters rely on much less useful --- and that was never more obvious than in July's stunning outperformance in the labor market.

There was widespread agreement among experts that the Fed's aggressive monetary tightening would slow domestic demand enough to put a chill on new hiring. Analysts predicted nonfarm payrolls last month would fall back to about 250,000, after registering an increase of 372,000 in June.

Chart 1. Unemployment rate, seasonally adjusted, July 2019 – July 2022

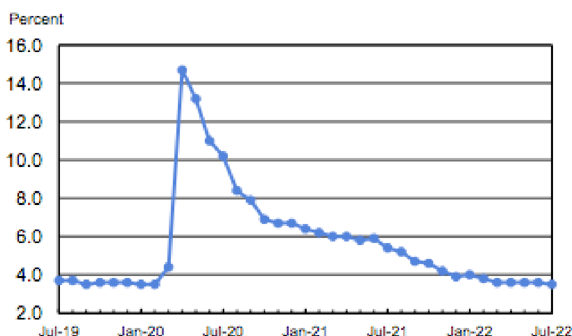
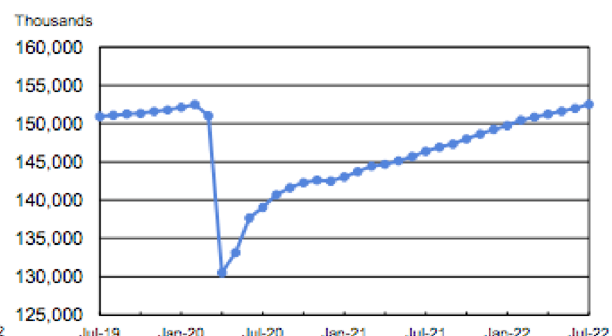
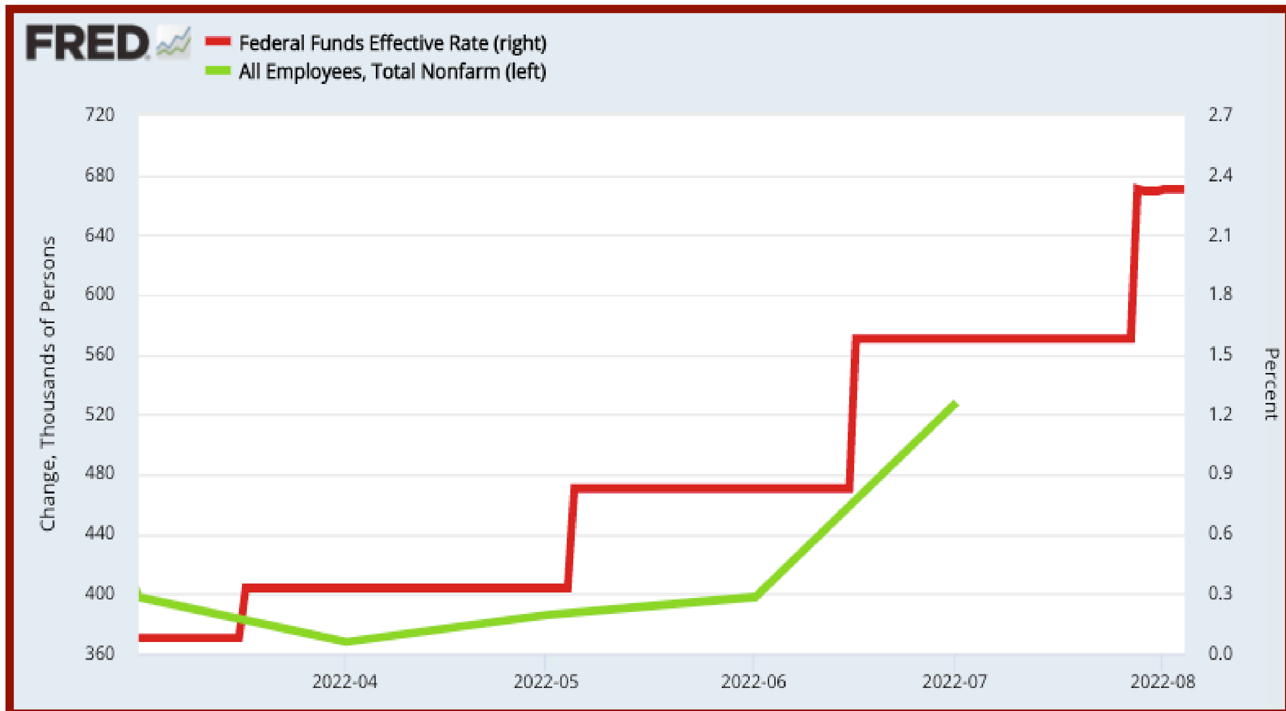


Chart 2. Nonfarm payroll employment, seasonally adjusted, July 2019 – July 2022



Then came the pie in the face moment. Monetary tightening did not slow hiring at all. Just the opposite. July's payrolls increased by a massive 528,000. Moreover they revised June's numbers up to 398,000. Companies were in fact recruiting new workers in far greater numbers than anyone thought ---- and this was happening when GDP growth contracted in the first half, suggesting that a recession is underway!!



How could that be?

Well, let's begin the botched forecasts. Most analysts are still shackled to an economic universe that is actually defunct. We have been arguing for a year that this is not your typical business cycle. The dynamics driving employment and inflation now have little in common with the past trends. And those forecasters who still cling to their traditional models will see the accuracy of their projections fade. They will consistently find themselves one equation behind in terms of projecting where the economy, inflation and employment are headed.

Recall that the Fed began to raise short-term rates last March, and they have tightened more aggressively in each subsequent meeting. Every voting member on the FOMC spoke of the urgency to slow the pace of hiring in the US in order to get inflation to roll over. Raising the cost of borrowing, they argued, "should" result in fewer new hires and ultimately "should" cool inflation. But the rules of the game have changed. Job growth since March has rocketed ahead and inflation remains at 40-year highs.

Let me zero-in on one of our favorite employment indicators in this jobs report, the staffing at childcare centers. A jump in hiring at these facilities suggests more parents are dropping off their young children and returning to work. Such licensed centers are usually mandated by states to maintain a certain ratio of staff to children

being cared for. The latest data shows employment at childcare centers the last two months rose at the fastest pace this year!

If the Fed thought tighter monetary conditions would drive the unemployment rate higher, the result, once again, turned out to be the reverse. Since March, the fed funds rate rose more than 200 basis points, yet the jobless rate fell to 3.5% in July, matching the lowest in half a century!

So what will the Fed do next?

I fully expect the Open Market Committee will continue to tighten monetary policy in an effort to crush inflation. But that would be a mistake in our opinion. What they consistently fail to realize is that this is a different inflation demon. We're confronting a global inflation problem triggered by global shocks. So even if the Fed ratchets up rates to the point where it sucks out all the oxygen from the economy, it will still not make much of a dent in bringing inflation close to the Fed's 2% target.

Again, the great albatross over the Fed's neck is not a super hot US labor market, but the destructive consequences of a highly unstable geopolitical and global economic environment.

Remember, before the onset of the pandemic, the US economy enjoyed a 50-yr low unemployment rate--- and job openings that were far greatly exceeded the number of people unemployed. Yet even under those tight labor market conditions, inflation STILL comfortably settled in the 2% range.

Now for the good news.

Inflation pressures are starting to recede despite the white hot US job market. This is not, as some have quipped, "the immaculate disinflation." The economic weakness underway in China, Europe and emerging countries has begun to reduce the price of key commodities, like copper, lumber, wheat and oil. The cost of gasoline in the US has also been sliding the past two months.

What Fed policymakers seem so reluctant to grasp is that they are being held hostage to geopolitical tensions, global supply chain disruptions and economic upheaval abroad. Those are the primary forces shaping inflation these days.

The bottom line is we see no reason why the Fed should view the current strong job market with alarm. Raising interest rates much more would unnecessarily choke off economic activity and precipitate a recession. What a shame that would be.

(Charts below)

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	-1.6	-0.9	1.2	1.0	-1.1	-0.2	1.9	2.3	2.1	3.3	2.4	2.8
Personal Consumption Expenditures:																
PCE %	11.4	12.0	2.0	2.5	1.8	1.0	1.8	2.4	-0.9	1.4	2.6	2.4	2.7	3.8	2.7	2.2
Inflation, end of period, year-over-year:																
CPI %	2.6	5.3	5.4	7.0	8.5	9.1	8.0	6.9	6.6	6.5	6.2	4.5	3.0	2.5	2.5	2.5
Unemployment Rate (end of period):																
%	6.0	5.9	4.7	3.9	3.6	3.6	3.6	3.7	3.9	4.0	4.0	4.2	4.0	4.0	3.9	3.6
Non-farm Payrolls, monthly avg. thousand:																
	513	615	651	365	562	384	310	295	290	310	325	255	275	310	315	325
Treasury 10-yr Note Yield % (end of period):																
	1.75	1.44	1.52	1.51	2.32	2.97	2.70	2.75	2.75	2.80	3.05	3.07	3.07	3.10	3.15	3.20
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.38	1.63	2.88	2.88	2.88	2.63	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	0.6	1.0	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	5.2	0.5	1.5	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	2.5	1.0	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	1.7	2.1	2.0	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	2.5	2.3	2.8
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	6.7	6.5	7.2
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	5.2	5.5
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	0.9	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	-8.5	5.0	1.8	1.5	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	4.7	2.8	2.4	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	-9.0	-2.0	1.9
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.7	--3.1	5.9	2.8	3.1	4.4

© Copyright 2022 ALL RIGHTS RESERVED
THE ECONOMIC OUTLOOK GROUP, LLC