The U.S. Economy Continues to Surprise the Experts, With a Major Reading on Inflation Due This Week to Add to the Noise

Economists and politicians alike are having trouble understanding an economy that has survived more than two years of pandemic shocks.

By Tim Smart
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Last week, economists eagerly awaited the July monthly jobs report from the Labor Department.

This would be the first real test of the Federal Reserve's anti-inflation monetary policy, following back-to-back 75 basis point hikes in interest rates designed to slow the economy by crimping demand and cooling off the labor market. Already, the second quarter gross domestic product had recorded a second consecutive contraction in output, a common though unofficial measure of a recession.

Estimates centered on a 250,000 monthly increase in jobs, with one Wall Street firm even suggesting the number would be 75,000. The actual number: 528,000 new jobs, restoring the economy to its pre-pandemic levels and driving the unemployment rate down to 3.5%, the same rate it was prior to the declaration of coronavirus as a global health emergency

"Today there are more people working in America than before the pandemic began. In fact, there are more people working in America than at any point in American history," President Joe Biden said from the White House on Friday.

But no good deed goes unpunished. As soon as the report was live, economists were out with their commentaries and while many celebrated the outsized number, there was also the worry this would mean an even more aggressive stance by the Fed that could still choke off the economy and bring on a recession.

"The decline in unemployment and the participation rate will frustrate central bankers since a tighter labor market adds inflation risk to the economy," Jeffrey Roach, chief economist for LPL Financial said on Friday.

"Markets are having trouble digesting the implications of the strong labor market in July. The big headline gain in jobs was a surprise and could convince people like San Francisco Fed President Mary Daly that the economy needs another 75 basis point hike at the Fed's next meeting. All eyes are now on inflation."

That is what is proving so confounding about the current economy and its recovery from a once-in-a-century pandemic. Experts misjudged how strongly it would come back following the sharpest and shortest quarterly downturn on record. And now they may be misjudging how it will handle the downshift to a more normal growth rate – and how resilient the job market will be going into the second half of the year and beyond.

"On the one hand, the exogenous events of the last near three years have fundamentally reshaped the structure of the US and international economy," **Bernard Baumohl, chief global economist at the Economic Outlook Group**, said. "This is not your typical business cycle. Nor is it not your typical employment pattern. The dynamics driving inflation also have little in common with past inflation cycles."

There will be yet another chance for the experts to weigh in on Wednesday, when the government reports the consumer price index for July. With inflation surprising to the upside in June, notching a 1.3% monthly gain that brings the annual rate to 9.1%, economists are looking for a downshift from June's 1.3% increase to 0.2% in July. That would bring the overall CPI to a 8.7% level.

But anything is possible. There have been some promising signs of a slowdown in prices, the most notable among them being the cost of a gallon of gas. Prices for a gallon of regular have fallen 68 cents in the past month to a national average of 4.069. That is still roughly a dollar above where they were a year ago, but it is a meaningful drop – and one that has the Biden administration cheering.

Following Russia's unprovoked invasion of Ukraine in late February, analysts said gas prices would rise – and they did – with some even warning of oil reaching $200 a barrel

Today, it is hovering near $95. But, as gas prices rose to $5 a gallon, drivers stopped using as much.

"According to new data from the Energy Information Administration (EIA), gas demand dropped from 9.25 million b/d to 8.54 million b/d last week," AAA said on Thursday. "The rate is 1.24 million b/d lower than last year and is in line with demand at the end of July 2020, when COVID-19 restrictions were in place and fewer drivers hit the road."

"Moreover, according to EIA, total domestic gasoline stocks increased slightly by 200,000 bbl to 225.3 million bbl," AAA added. "If gas demand remains low and stocks continue to rise alongside falling crude prices, drivers will likely continue to see pump prices decrease."

The decline in the price of energy, a key component in many items ranging from gasoline to agricultural fertilizers, would have a ripple effect throughout the economy and help bring inflation under control. But strong demand for labor could keep pressuring wages, another key factor in overall inflation.

“This is not an economy in recession,” James McCann, chief deputy economist at abrdn, said on Friday. “A very tight labor market is generating strong wage pressures, which are likely well in excess of those consistent with the Fed’s mandate.”

While Fed Chairman Jerome Powell said last month the central bank would take into account all the incoming data before hiking rates further, he also indicated that another 75 basis point hike would not be out of the question at the Fed’s next meeting in September.

On Saturday, Federal Reserve Governor Michelle Bowman said that “similarly sized increases should be on the table until we see inflation declining in a consistent, meaningful, and lasting way,” according to CNBC.

And with Wednesday’s report on the CPI looming over the markets this week, expect a to and fro between moods on Wall Street and among economists.

“In short, the economy has undergone a mutation of sorts due to the cumulative impact of the pandemic, supply chain vulnerabilities, looming geopolitical risks, and a realignment in globalization,” the **Economic Outlook Group’s Baumohl** said.

“And yet, we continue to rely on forecasting models that cannot possibly incorporate such historic and permanent changes,” he added. “The Federal Reserve and many private economists appear shackled to an economic paradigm that no longer exists. The result: too many economic forecasters increasingly find themselves one equation behind with what is happening in the real world.”

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