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ECONOMIC TALKING POINTS

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January 12, 2022

The Fed must not overreact to 7% inflation

We now have a 7% handle on CPI for 2021, the largest annual increase in 39 years! Take out food and energy and consumer prices leaped by 5.5%, a three-decade high!

For many analysts, the CPI has now entered that high-altitude, vertiginous level that calls for immediate and aggressive action by the Federal Reserve. Expect a chorus of inflation hawks to howl at an even higher decibel on the need for the Fed to kick-up interest rates four or five times this year --- and to begin the first increase now, not wait for March.

Critics believe the Fed has fallen farther and farther behind the inflation curve. The delay to combat this trend in 2021 means they have to hit the monetary brakes harder this year to make sure that prices do not spiral out of control as they did during the 1970s. That is the exhortation you will hear repeatedly in the coming days.

Frankly, we hope the Fed will be unmoved by these urgings.

Look, we're not known for being contrarians; that is not our intention here. But there is a credible case to be made that argues against any rapid-fire increases in rates. Let's just list a few here:

1. The current escalation in consumer prices has nothing to do with an economy that is overheating. It has everything to do with the disruptive fallout from the pandemic. And while the literatus of the economics profession found the term "transitory" terribly delusive, the reality is inflation is as transitory as Covid is transitory. If the latter is not transitory, then we've got much bigger problems than just rising prices.

2. Economic activity is already slowing sharply from last year's pace, and not just in the US but globally! The World Bank yesterday issued a report that saw global growth moderating from 5.5% in 2021, to 4.1% this year and 3.2% in 2023. Most forecasters see US economic activity also decelerating in 2022, as do we. When aggregate demand is weakening, it takes some steam out of inflation. Thus the risk of a policy mistake is high if the Fed chose to stamp its foot on the monetary brakes with four or more rate hikes this year *when economic activity is already backpedaling*. To have both would likely end this economic story with a familiar epilogue --- recession.

3. Financial market conditions have been getting tighter. With the Federal Reserve shutting down QE in March, we will see market rates move higher. The benchmark 10 yr treasury yield, which last month slid to 1.3%, has already shot up 40 basis points. That alone can dampen spending and borrowing in the economy. Further increases market rates are expected and this could obviate the need for the Fed to act swiftly and aggressively.

4. There are also glimmers of hope the paralysis in the global supply chain is getting resolved. The Federal Reserve Bank of New York crafted a new metric, called the Global Supply Chain Pressure Index (GSCPI). It combines several existing measures that track goods being shipped around the world, along with transportation prices. The report's conclusion: "….*the GSCPI seems to suggest that global supply chain pressures, while still historically high, have peaked and might start to moderate somewhat going forward*."

This improving trend was also acknowledged in December's ISM release on U.S. manufacturing activity, which noted *"…there are clear signs of improved delivery performance."* In fact, the supplier deliveries index in December was the fastest since November 2020. And as more goods flowed through the economy last month, there were fewer instances of scarcity among critical products. That brought the prices paid index down to a 13-month low.

5. It is true that wages have been on a tear lately and this does have the potential of evolving into a vicious wage-price spiral. But let's take a deep breath. We have for the moment an extraordinary demand for workers colliding with a smaller pool of unemployed who are actively seeking a position. That's the situation we face *this winter* as the twindemic of the Omicron and flu take a toll on labor force participation. However, with more people getting fully vaccinated, the Omicron threat is expected to recede this spring. That development, and the fact households have seen their savings rate plummet (it is currently the lowest in 4 years), should bring more Americans back into the labor force.

Let's not forget that wage inflation remained remarkably modest prior to the pandemic when the unemployment rate dove to a 50-year low of 3.5% (it's now 3.9%), AND we faced the same predicament back then of having more job openings than job seekers. In other words, a tight labor market does not inexorably bring on problematic wage inflation.

6. Fiscal policy is turning more restrictive in 2022 compared to the last two years. The high-octane fuel that sparked so much spending in 2021 were the multiple paychecks that Washington mailed directly to households. No such program is in the works for 2022.

Conclusion:

What is worrisome is that too many inflation hawks view current conditions in purely linear terms. That is, they instinctively assume that the way prices behave now is how they will perform the rest of the year. What's missing from that assessment is that we are in the midst of an anomalous business cycle, one marked by unusually rapid, even violent, turnings points in consumption, output, employment, inventory and, yes, prices! Yet the underlying physics of a modern competitive market economy has not changed. The US has an incredibly dynamic and self-adjusting economy. Market forces will re-emerge in force this year and begin to cool inflation pressures. It has been said before and bears repeating, *the answer to high prices…is high prices*. In fact, there are fresh signs the CPI may be close to cresting. December's increase was the second straight month that saw consumer prices decelerate. It rose 0.5% last month, down from 0.8% in November and 0.9% in October.

Should the Fed choose to finally part from its zero bound policy at its mid-March meeting with a 25 basis point hike, that's fine. We see no danger in that. Nor would we be concerned if a second increase occurred this year.

But before the Fed considers kicking up rates 100 basis points or more in 2022, we hope those on the FOMC will pursue a more judicious approach. Let's wait and see if --- in the next 5 to 6 months --- inflation begins to turn down on its own due to (a) the untangling of the supply chain, (a) an increase in the labor force participation rate, (b) a build up of excess inventories as goods arrive belatedly after the holiday season, (c) lower prices paid by manufacturers, (d) less fiscal stimulus from Congress, (e) the impact higher long term rates have on shopping and debt, (e) and slower worldwide GDP growth.

Only then will we have a better grasp of the actual inflation dynamics underway in the economy.

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	6.2	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	6.8	2.4	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	6.5	6.1	5.5	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	1.82	1.75	1.70	1.90	2.10	2.10	2.26	2.35	2.35	2.45	2.53	2.45
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.63	0.88	1.13	1.38	1.63	1.63	1.63	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	2.5	3.1	1.7	2.3	3.0	2.2	-3.5	5.4	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	4.9	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	5.0	4.2	2.7	2.2
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	6.6	5.9	5.6	5.1
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	-8.4	5.9	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	4.1	2.9	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	4.8	3.6	3.2

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