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ECONOMIC TALKING POINTS

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The Fed's Aggressive Rate Policy May Do More Harm Than Good

There's an old Chinese proverb: *"It is not economical for a couple to go to bed early to save on candles if the results are twins."*

I bring this quip up because it contains a lighthearted but also earnest warning for the Federal Reserve.

How so? One can certainly understand why the Fed chose at this meeting to hike its benchmark short-term rate 75 basis points and also alert everyone that additional aggressive actions would come. After all, CPI inflation had just accelerated to a four-decade high rate of 8.6% and inflation expectations were rising as well. So the Fed's goal was unambiguous here. Slow down economic activity enough for inflation to roll over. No one should doubt the central bank's ability to depress demand if it seeks to do so. But unlike past episodes of monetary tightening, economic weakness -- *this time* --- will not materially bring prices down. That's because this is not a typical inflation cycle.

What makes this inflation cycle unique? By our assessment, some 80% of the forces driving prices higher stem from shocks outside the US. Even the Fed's own press release assigns much of the blame for elevated inflation on external shocks, specifically the pandemic, high global energy prices, war in Ukraine, and how China's Covid lockdowns further gummed up the world's supply chain. And therein lies the Fed's dilemma.

Jerome Powell and his colleagues are largely captive to these exogenous events. They can act to slow domestic growth, but it can't pressure Putin to end the war. Nor can the Fed chairman take steps to increase oil refining capacity or induce OPEC to boost production, build more LNG plants, or hasten the flow of goods in the supply chain. Yet these are the real culprits that fired up inflation in the US and around the world.

So we have to raise the obvious question. Does the Fed's super hawkish approach make economic sense? Its willingness to furiously ratchet up the benchmark rate to 3.4% by the end of this year and to 3.8% in 2023 is a clear signal to financial markets that Powell and his colleagues will be relentless in roping in inflation. They want to quash any notion that they are still behind the curve.

But acting tough this time may end up causing more long term damage to the real economy. To begin with, business activity is already decelerating. Housing, auto purchases and retail sales are all down. Nonfarm payrolls last month grew at the slowest pace in more than a year. Consumer sentiment has just tumbled to its lowest level ever! If Americans were already in the process of shutting down spending, slamming the monetary brakes now would only doom the country to a prolonged period of stagflation (if not recession).

There is one other issue to consider. Fed policymakers have long held on to the belief that changes in monetary policy impact the economy with long and variable lags, usually 12 to 18 months later. But there is a growing body of evidence that suggests the transmission mechanism is now actually much quicker, more like 8 weeks to six months. This acceleration has been driven by two factors. The first is the proliferation of technology, such as online shopping between business-to-consumers as well as business-to-business. If needed, vendors can adjust prices, policies and products faster than they have in the past. Just take a look at how retailers and wholesalers are rushing to unload excess inventories.

The second factor is demographics. There is a whole generation of Americans that has never experienced high inflation or sharply rising interest rates. Sticker shock on food, shelter and gasoline prices, and the surging cost of borrowing have led these consumers to alter their spending behavior much sooner than past economic cycles.

So we come back to our original concern. Sharply higher interest rates will undoubtedly depress demand. However, it will do little to cool inflation since its multiple causes are beyond the Fed's reach.

Indeed, the greater risk is that the Fed will end up sabotaging productive investments in the business community, those meant to offset the labor shortage and address supply chain problems. Companies have been ramping up outlays in the past year so they can increase production of goods and services without necessarily hiring more workers. Moreover, to simplify supply chains, firms were allocating fresh capital toward vertical integration by acquiring their supplier(s) or purchasing a fleet of cargo-carrying ships all to assure a reliable stream of supplies in the future. Unfortunately these expenditures, which were designed to improve operating efficiencies, could now come to a screeching halt if CEOs sense a recession is unavoidable.

Another unfortunate side effect of the Fed's hawkish actions is it will disrupt a socially valuable development in the labor market. For the first time in modern economic history, the competition to find scarce workers created an opportunity for those stuck in low wage, menial jobs to be recruited and trained for better paying positions. This shift toward upward mobility has been underway the last two years. Case in point: The unemployment rate for those who lack a high school diploma has plummeted 15.9 percentage points since the April 2020 jobless peak. No other educational demographic comes even close to such a drop in joblessness! But, again, sharply higher interest rates will abruptly halt this hugely positive change.

For all these reasons we question the wisdom to dramatically accelerate rate increases. This is not your grandfather's inflation cycle. If the Fed chooses to pursue an aggressive monetary strategy, it could backfire on the economy.

It is interesting to note that at least one major central bank has chosen to part ways with the Fed (and with most other major central banks). Japan has also seen inflation creep higher than desirable, yet the Bank of Japan has deliberately chosen to keep rates low. Given its alternate path, it will be interesting to see how these two economies fare in the months ahead.

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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	-1.5	1.9	1.6	2.1	0.9	1.4	2.0	2.3	2.1	3.3	2.4	2.8
Personal Consumption Expenditures:																
PCE %	11.4	12.0	2.0	2.5	3.1	3.3	1.8	2.4	1.2	2.0	2.3	2.0	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	8.7	7.8	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	3.7	3.9	4.3	4.6	4.9	4.5	4.1	3.8	3.6	3.6	3.5
Non-farm Payrolls, monthly avg. thousand:																
	513	615	651	365	562	375	245	195	190	190	210	255	275	310	315	325
Treasury 10-yr Note Yield % (end of period):																
	1.75	1.44	1.52	1.51	2.32	3.47	3.30	3.05	3.05	2.99	2.85	2.80	2.10	3.10	3.15	3.20
Federal funds rate % (end of period):																
	0.13	0.13	0.13	0.13	0.38	1.63	2.63	2.88	2.88	2.88	2.88	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	1.5	1.1	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	1.8	2.2	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	2.9	1.4	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	2.8	2.5	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	6.2	6.5	6.8
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	5.6
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	0.9	2.2	2.5
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	1.2	2.4	2.8
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	-12.0	-2.6	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

Key Economic & Geopolitical Projections for 2022 & 2023

- Latest revision: June 16, 2022

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PROBABILITY	U.S.
HIGH	Forecast assumption: Russia ends war in Ukraine early (2023). Commodity prices stay elevated globally thru 2022.
HIGH	Fed's aggressive rate hikes doom economy to stagflation in 2H. Economic activity weakens, but inflation remains high.
Moderate	Odds of US recession 45% this year, but jumps to 80% in 2023 as higher rates choke off economic activity;
Moderate	Treasury 10-yr. yields hovers between 3.00% to 3.50% the next 12- 18 months as inflation remains elevated .
HIGH	Lethal threat of Covid virus recedes; but Africa remains a breeding ground for variants given low vaccination rates.
HIGH	Supply chain bottlenecks to ease at ports in 2H, though some goods will lag others in terms of their availability.
	FOREIGN
HIGH	Russia's economy is imploding. GDP to contract 10% - 15% in 2022, and another 3% in 2023.
HIGH	Regime change in Russia to be a prerequisite before the country can rejoin the international community.
HIGH	Beijing fortifies naval presence in South China Sea and Taiwan Straight to counter US military support of Taiwan.
HIGH	China's 2022 growth decelerates to 4.0% - 4.5% as Covid lockdowns and property market shakeout take their toll.
Moderate	A cyber World War is underway; Prepare for periodic disruptions to global financial networks and power grids.
Moderate	Iran can now produce enough fissile material for a nuclear bomb. Israel is unlikely to sit by.
HIGH	Recession odds in Eurozone jumps to 80% in late 2022/2023 as the ECB lifts rates and energy prices surge.