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ECONOMIC TALKING POINTS

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Why The Fed Should Freeze Rates The Rest Of 2023

The Federal Reserve meets this week to decide on interest rate policy and I expect they will take no further action, thus keeping fed funds at 5% - 5.25%. Unfortunately, that promises to stir up more linguistic babble whether this represents a "pause" or "skip." It's a silly debate because most Fed officials genuinely are unsure where monetary policy goes next.

Much depends, of course, on whether inflation continues its downward trajectory toward 2% (without assistance from a recession). If that occurs, then --- OK, here goes---this week's "pause" will remain a "pause." Or, if you're so inclined the "skip" becomes a "pause."

On the other hand, if disinflation stalls -- or worse should prices suddenly pick up again -- then clearly the "pause" converts to a "skip." You get it. But let's step away from this verbal muddle.

Look, the Fed's primary goal is to make sure inflation pressures are genuinely cooling, and we'll get fresh data on that this Tuesday with the CPI report for May. But there's an important point to be made first. It is unrealistic to expect the CPI or PCE prices to dive bomb toward the Fed's 2% target. Rarely in economics does anything move in simple linear fashion. Instead, what officials seek is for inflation to make sustained progress toward that goal. And it's fair to conclude that all the major inflation metrics -- so far -- are moving in the right direction, as I will show below.

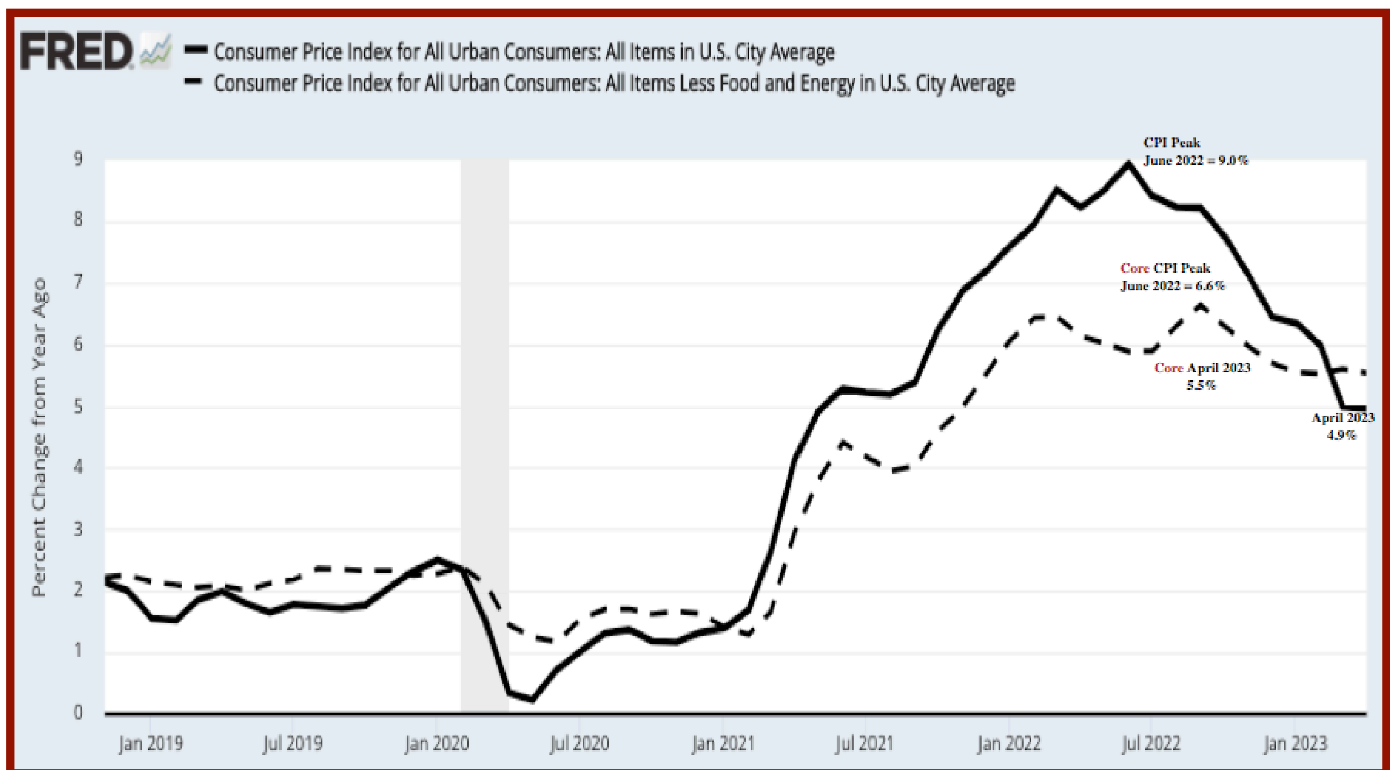
The looming question is whether Fed policymakers are content with the <u>*speed*</u> inflation is falling. We'll get a hint of that with the latest release of the Summary of Economic Projections on Wednesday when the Fed wraps up their meeting. But let's be clear: What is evident up to this point is that inflation has been in retreat --- and I expect that overall trend, while choppy, to continue. Bottom line: There is no dire need for the Fed to kick up rates simply because the economy is still generating lots of jobs.

What's worrisome is that some inflation hawks have an historical memory that only goes back to breakfast. Case in point: Let's revisit how well the economy performed just prior to the pandemic. In 2019, the unemployment rate *averaged 3.5%,* the same it has so far in 2023. *Job openings significantly exceeded the number of people unemployed back then too*, so labor market conditions were also quite tight in 2019. (Clearly the hunt for talent did not commence in the post-Covid era.) Average hourly earnings in 2019 rose 3.3%, which is admittedly less than the 4.4% pace in the current year.

So…how did inflation perform in 2019 given the macroeconomic similarities to current conditions? The Fed's preferred gauge, the PCE price index, could barely tread water at 1.5%! That's right it stubbornly held ***below*** the Fed's target! What this tells us is that it is entirely possibly to bring inflation down without attacking the job market. Frankly, I always found the argument tinny that the Fed must boost the unemployment rate to successfully achieve 2% inflation. That's rigid thinking, one handcuffed to an effete Phillips Curve.

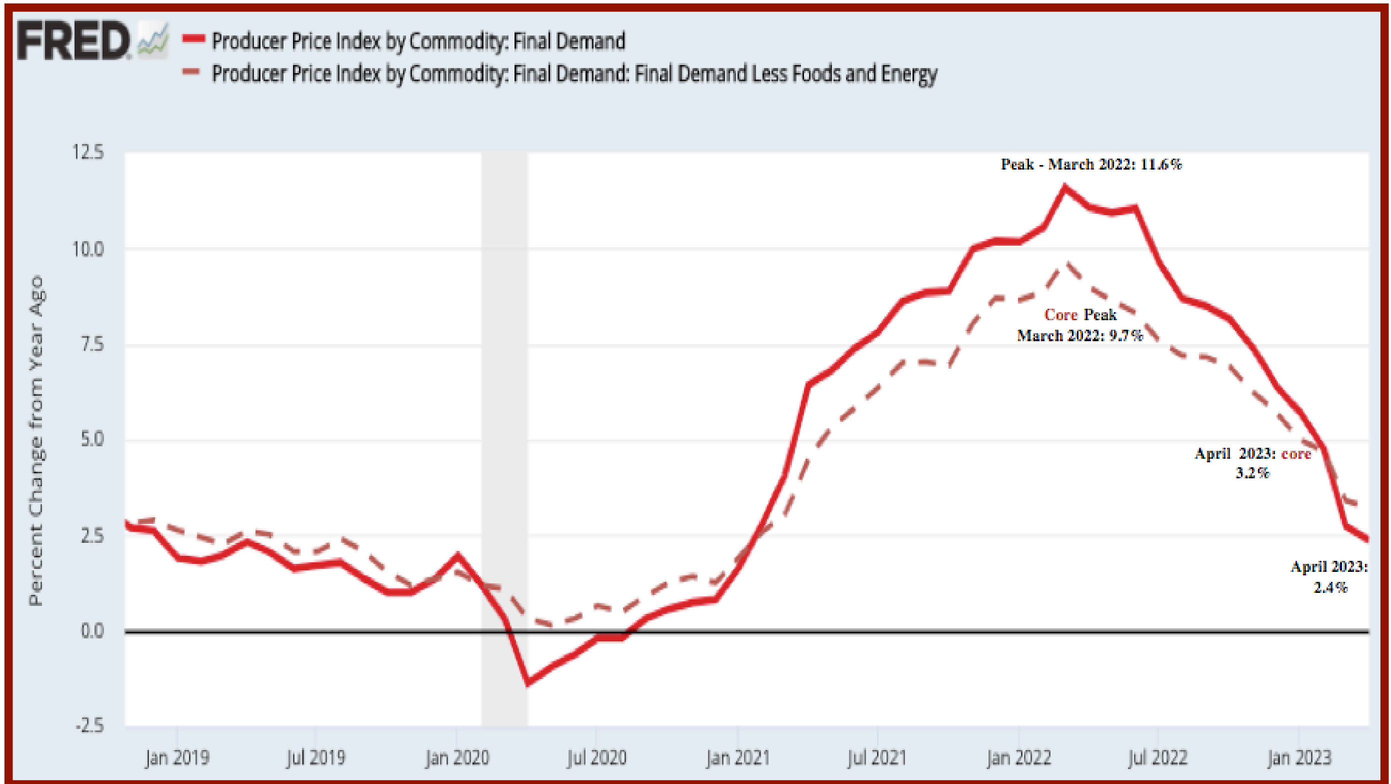
So here is what recent data has revealed about inflation. **Headline CPI has been melting, with core inflation shrinking more slowly.**

Chart 1. Headline (solid line) and core CPI (dash line), % change year over year



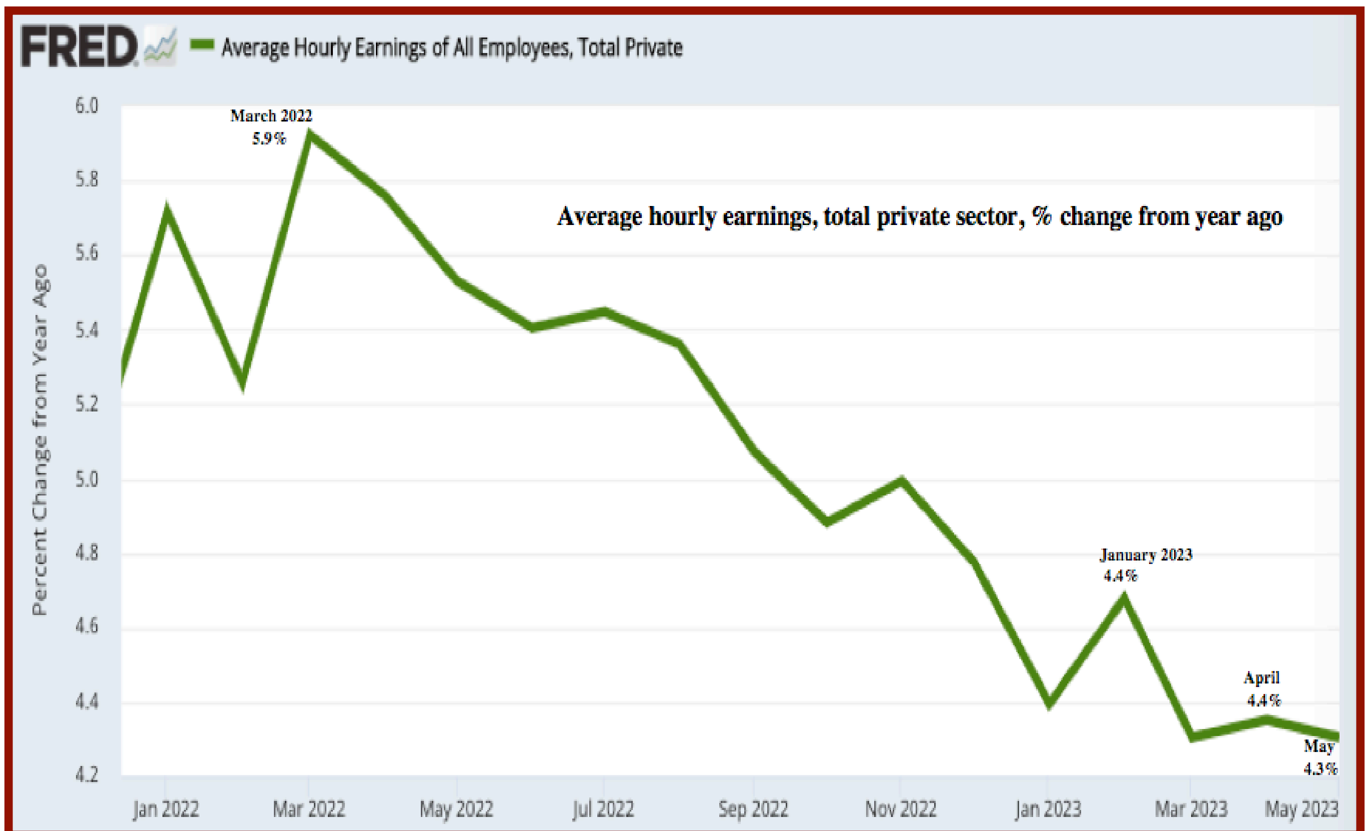
Next, both top line **Producer prices and core on final demand for commodities** are plummeting. This tells us essentially what retailers pay their suppliers. Given the sharp drop in producer prices, we should expect retailers to soon pass some of those lower costs on to consumers.

Chart 2. Headline & Core Producer prices for finished Goods, % change year over year



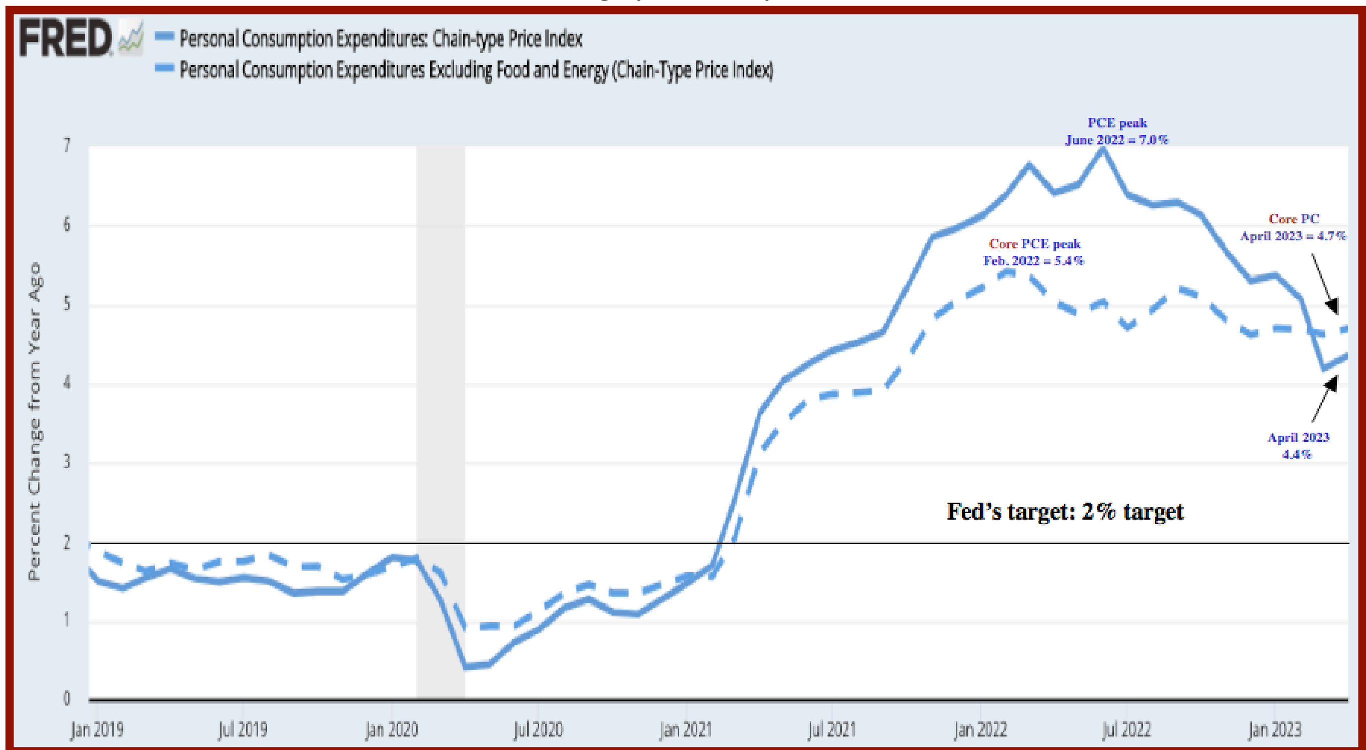
Nor has there been an intensification of wage pressures, as you can see from average hourly earnings versus a year ago.

Chart 3. Average hourly earnings, % change year over year



The Fed's preferred inflation metric, the percentage change in the PCE price index, has also tracked downward, but the road has been far bumpier.

Chart 4. PCE and core PCE inflation, % change year over year.



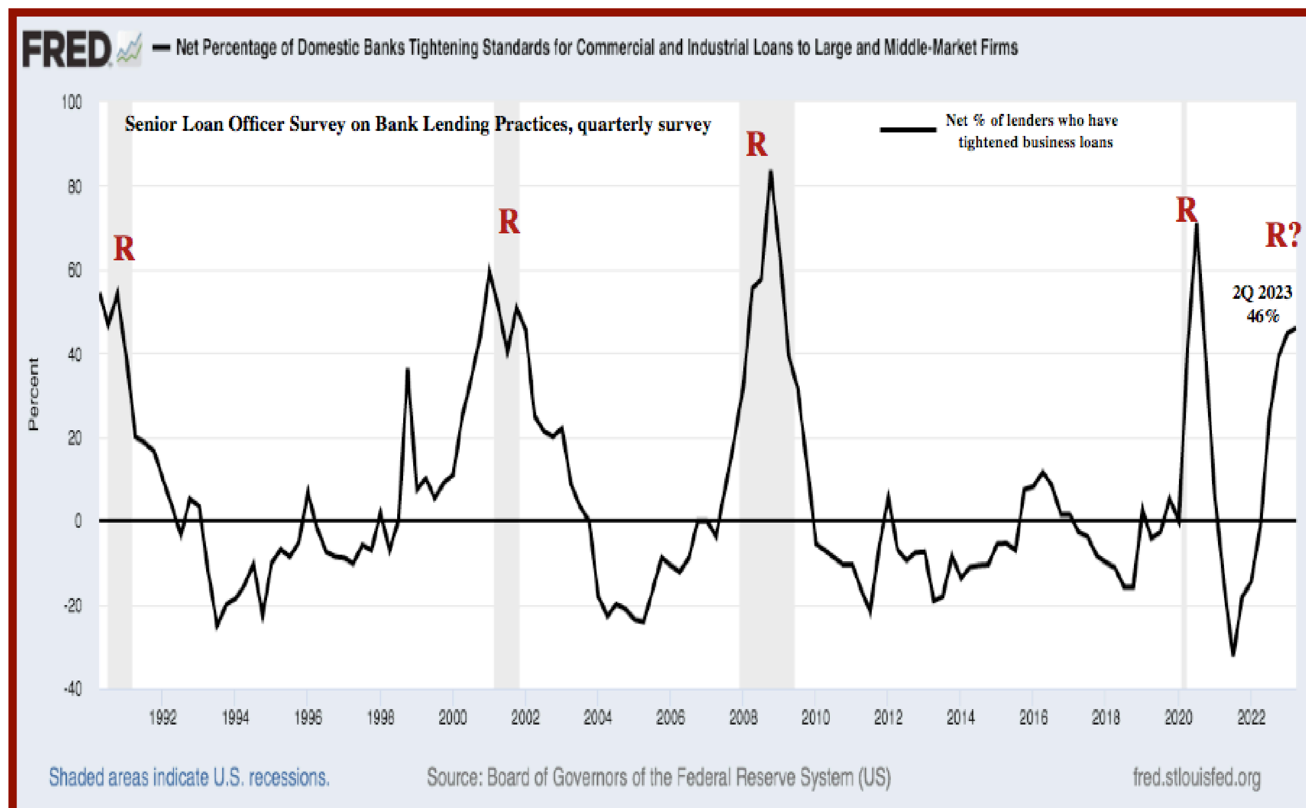
And there additional reasons why the Fed should stand pat in the second half of 2023.

- After hoisting the fed funds rate at the quickest pace in 40 years, there's some relief the Fed has not broken anything in the economy *yet!* But cracks are starting to appear. Lifting the policy rate to a 16 yr high over a 14-month period already proved too much for some regional banks. The subsequent collapse of Silicon Valley Bank and First Republic Bank are a testament of that. While the situation appears contained for now, another round of monetary tightening could fracture other small and medium sized banks. Regulators understand that financial stability is absolutely paramount in a market economy. Without that stability, consumer and business spending abruptly stalls.

- Moreover, the Fed knows well that the full effects of the 500 basis point jump in rates have still not been fully felt in the economy. So it is well worth being patient to see how those higher borrowing costs will impact economic and financial conditions.

- **Credit conditions have also tightened considerably.** As you can see from the chart below, senior bank lending officers have pulled back on loans to business close to levels that have helped trigger recessions in the past.

Chart 5. The net increase among senior U.S. bank lending officers who say they've tightened.



• Nor should we ignore how quickly and massively the government is presently withdrawing liquidity from the economy. Not only is the Fed still implementing quantitative tightening, (e.g., as of the end of last month, it successfully shrunk its portfolio of securities by some $800 billion since March of 2022), but with the debt ceiling now suspended until early 2025, the Treasury department wasted no time to replenish its nearly depleted cash account. It rushed to borrow hundreds of billions of dollars ($359 billion on just one day after the President signed Fiscal Responsibility Act of 2023). That sops up a lot public savings that could have been used as private investment capital.

With liquidity being drained simultaneously from QT and a cascade of Treasury debt issuances, how could the Fed even rationalize the need of more rate increases, especially given the current downward trajectory of inflation?

• There are also two other major risks the Fed must consider. (1) More than 40 million Americans will have to resume making student loan payments in late August under current law. That means less spending by these consumers this fall and winter.
(2) Another major unknown is how the weakened commercial real estate sector will fare under the strain of higher refinancing costs? A blood bath in the CRE industry could engulf banks and other creditors, especially those exposed to office building sector.

• Finally, let me also toss in what I suspect is a deeply hushed concern within the Fed and that is the danger that more rate hikes could bring on a painful recession at the worst possible time. We are approaching the eve of what promises to be a ferocious 2024 presidential campaign. If a recession materializes, this central bank would instantly get sucked into that raging political black hole.

So what does all this mean for future Fed policy? I believe (and hope) they are done for the year, with fed funds topping out at the current 5% - 5.25%. The case for the "pause" is that inflation pressures are cooling, access to credit is already becoming more difficult and costly, and that economic growth is gently moderating.

And while there has been speculation of actual rate cuts before this year is out, I see only a 20% chance of that occurring. The Fed will begin to gradually loosen monetary policy in the first quarter half 2024. Until then, let's at least hit the pause button on further monetary tightening.

United States

	I 2022	II 2022	III 2022	IV 2022	I 2023	II 2023	III 2023	IV 2023	I 2024	II 2024	III 2024	IV 2024	I 2025	II 2025	III 2025	IV 2025
Real Gross Domestic Product (GDP):																
%	-1.6	-0.6	3.2	2.6	1.3	1.5	2.1	1.9	1.3	3.0	2.2	2.6	1.7	1.9	3.0	2.6
Personal Consumption Expenditures:																
PCE %	1.3	2.0	2.3	1.0	3.8	2.3	1.2	2.0	1.5	2.9	3.1	2.7	1.7	2.8	3.1	2.9
Inflation, end of period, year-over-year:																
CPI %	8.5	9.1	8.2	6.5	5.0	4.4	4.2	4.0	3.7	3.7	2.8	2.6	2.6	2.5	2.5	2.5
Unemployment Rate (end of period):																
%	3.6	3.6	3.5	3.5	3.5	3.7	3.9	4.1	4.1	4.0	3.9	3.8	3.8	3.7	3.5	3.5
Non-farm Payrolls, monthly avg. thousand:																
	561	329	423	291	295	280	220	225	180	240	285	260	200	265	310	270
Treasury 10-yr Note Yield % (end of period):																
	2.32	2.97	3.80	3.83	3.47	3.38	3.28	3.35	3.20	3.35	3.60	3.65	3.60	3.48	3.35	3.35
Federal funds rate % (end of period):																
	0.38	1.63	3.13	4.38	4.88	5.13	5.13	5.13	5.13	4.88	4.38	4.13	3.88	3.63	3.13	3.13

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	2.2	2.9	2.3	-2.8	5.9	2.1	1.5	2.5
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.8	1.6	-6.2	5.2	3.6	0.8	1.7
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.7	1.7	-9.3	7.6	4.1	-0.1	1.1
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	1.7	0.6	-0.2	-4.6	1.7	1.0	1.2	0.9
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.8	1.9	-5.2	4.5	3.5	1.3	2.2
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.4	3.8	-6.6	8.7	6.7	5.6	6.6
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.7	6.0	2.2	8.1	3.0	5.1	5.4
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.7	-4.2	4.6	2.9	1.5	2.3
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.2	-0.2	-8.3	4.8	3.1	2.5	2.2
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	3.7	2.1	2.8
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.8	2.2	-2.7	4.7	-2.1	-1.1	2.2
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.6	--3.2	6.0	3.1	2.3	3.1

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