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A Close VIEW

Remaining Constructive on the Outlook

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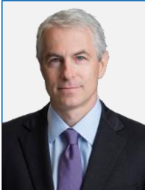

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Yes, there's reason to worry about inflation and the Federal Reserve's hawkish pivot. But there are also reasons to remain constructive about the outlook. Here are three.

Chair Powell's post-FOMC press briefing in January and the most recent CPI print set off another market re-evaluation of the likely path for the policy rate, with investors bringing forward additional rate hikes into 2022. Not surprisingly, the prospect of the Federal Reserve acting more forcefully to bring inflation down to the central bank's two percent objective has led to further flattening of the Treasury curve. In fact, the 2- to 10-year nominal Treasury curve two years forward reveals a degree of flatness more typical of an approaching recession. The forward curve was at similar or lower levels in 2000 and 2007, shortly before the start of downturns (Figure 1).

FIGURE 1: 2-TO 10-YEAR TREASURY CURVE SPREAD, 2 YEARS FORWARD

Data as of February 11, 2022
Source: Bloomberg. Shaded areas represent recessions

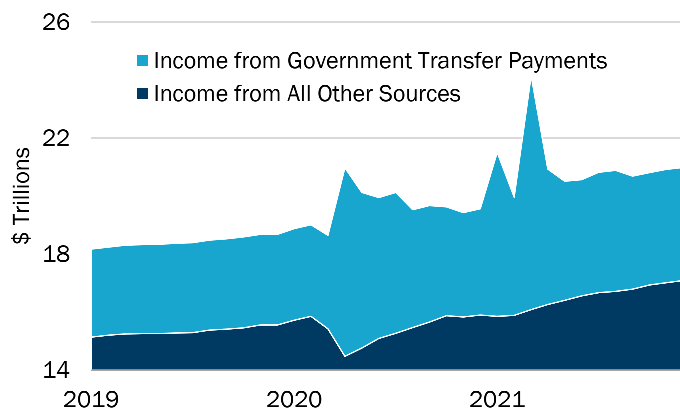
Despite these market signals and public concern about the ability of the Federal Reserve to achieve price stability without jeopardizing the expansion, there are a number of reasons to remain constructive on the outlook. Here, I highlight three. First, with the end of unprecedented fiscal support for households, real spending is now moderating. Inflation should follow suit. Second, reduced transfer payments and lower health risks are likely to boost labor supply, lessening upward pressure on wages. Third, the Fed's new flexible average inflation targeting framework should reduce the risk of excessive policy tightening.

Fading Fiscal Support

Perhaps the primary contributor to last year's inflation surge was the unprecedented support to household income found in the American Rescue Plan (ARP). The ARP and the two prior rounds of pandemic relief were critical for replacing household income lost during the pandemic and preventing significant hardship for millions. And the expansion of the child tax credit in the ARP temporarily reduced child poverty.[1] But as the plan erred on the side of doing too much in the fog of a pandemic, and was delivered at a point when the economic recovery had already made meaningful progress, it ultimately contributed to a surge in consumer spending and inflation, especially for goods.[2]

1. "December Child Tax Credit kept 3.7 million children from poverty," Center on Poverty and Social Policy, Columbia University, 20 January 2022.
2. Non-commodity goods accounted for roughly 2.2 percentage points of last year's seven percent rise in CPI inflation, compared to an average annual contribution of less than 0.1 percentage point in the five years preceding the pandemic. Meanwhile, core services contributed about 50 basis points more to total CPI inflation in 2021 compared to the pre-crisis average. Source: Bureau of Economic Analysis, MacKay Shields.

FIGURE 2: AGGREGATE HOUSEHOLD INCOME, SAAR

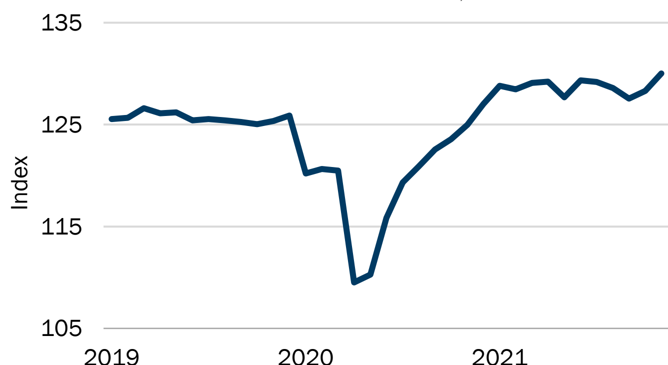


Data as of December 31, 2021

Source: Bureau of Economic Analysis

Now, with pandemic-related fiscal transfers in the rear view mirror, total nominal income is returning to its longer-run trend (Figure 2), and inflation-adjusted consumption has begun to moderate in recent months, according to the Bureau of Economic Analysis. In addition, global production has picked up following the worst of the supply-chain related disruptions in the middle of last year (Figure 3).

FIGURE 3: GLOBAL INDUSTRIAL PRODUCTION, EX. CONSTRUCTION



Data as of November 30, 2021

Source: Netherlands Bureau for Economic Policy Analysis

With fiscal transfers to households returning to more typical levels, demand for goods easing and global output showing signs of improvement, a better balance of supply and demand should reduce inflation pressures over the course of this year and next.

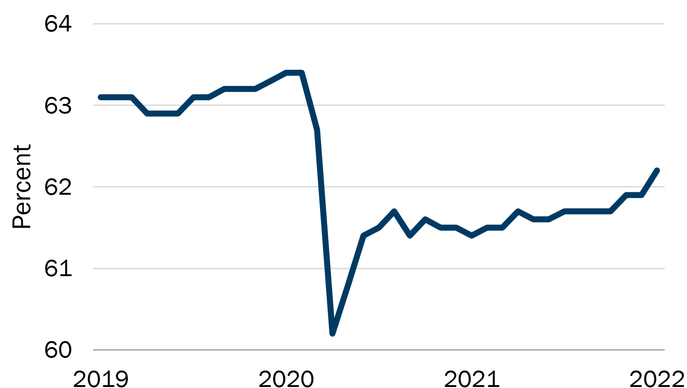
Improving Labor Supply

As the economy reopened after the spring lockdowns of 2020 and consumer spending surged in 2021, wages rose significantly in many sectors as firms looked to attract back workers. However, several factors served to constrain labor supply, including early retirements, ongoing health concerns, and family care responsibilities. Fiscal support for households contributed as well, as many civilians felt less financial pressure to return to work. Today, a still-high level of job openings in many sectors reflects strong labor demand, which could lead to further wage increases that businesses attempt to pass along to customers.

Fortunately, there has been positive news on labor supply in recent months. After plateauing through the middle of last year, the share of the working-age population in the labor force has picked up recently (Figure 4). Fading fiscal support has likely spurred many to return to the labor force. Less fear of COVID may be contributing as well. Reflecting this, a recent Axios/Ipsos poll found that almost half of respondents now favor moving towards some semblance of life as usual.[3]

Barring a new, more lethal variant of COVID, the cost-benefit tradeoff of returning to the labor force will become more favorable as the Omicron surge continues to fade. Many people who have remained on the sidelines are likely to return to work. The improving labor supply should, in turn, lead to a moderation in wage gains and cost-push inflation pressures as the year progresses.

FIGURE 4: LABOR FORCE PARTICIPATION RATE



Data as of January 31, 2022

Source: Bureau of Labor Statistics

Flexible Average Inflation Targeting

Much of the market focus on the Federal Reserve's new Flexible Average Inflation Targeting regime (FAIT) has centered on the conditions for liftoff, especially the Committee's indication that the policy rate would remain at its current level until the labor market returns to maximum employment.[4] But the liftoff conditions only represented a commitment device to support the new FAIT regime. More importantly, the Committee has jettisoned its prior approach of leaning against a strong labor market based on the assumption that low unemployment will lead to higher inflation in the future.

Without a doubt, the conditions for liftoff have left the FOMC flat-footed and behind the curve—the Committee has significant catch-up to do to remove policy accommodation.

3. "As Omicron recedes, Americans unsure on how to live with pandemic long-term", Ipsos.com, 8 February 2022.
4. The other two liftoff conditions have already been met, specifically, inflation (1) back up to two percent and (2) expected to moderately exceed that level for some time.

But the new framework implies that if inflation moderates over the course of the year and shows signs of trending lower in 2023, the Committee may ultimately choose to leave the policy rate at a neutral setting and avoid taking it into restrictive territory.[5] A strong labor market by itself no longer necessitates policy tightening, as was the case in past cycles. This is an important distinction that suggests better prospects for a long expansion. In short, the new framework likely reduces the risk of excessive policy tightening that in the past has led to recessions.

Developments in late 2018 and into 2019 are instructive on this front. As shown in Figure 1, the forward Treasury curve flattened significantly ahead of the 2001 and 2007 recessions, but also in 2018 when the FOMC appeared intent on raising the policy rate above neutral. But early in 2019, the Committee signaled an end of rate increases. This pivot, and subsequent cuts to the policy rate, would have likely succeeded in engineering a soft landing for the economy, if not for COVID.

The Committee had not yet adopted FAIT in 2019, but it had already announced a policy strategy review in late 2018.[6] The review was motivated by an appreciation that structurally low interest rates reduced the Committee's scope to provide stimulus in a downturn, that strong labor markets had not triggered a rise in inflation, and that the Committee had largely failed to meet its inflation objective in the post-Great Recession recovery. These factors behind the strategy review were already influencing policy decisions in 2019, even if the strategy had not yet been formally changed. The pivot away from further rate increases that year is a prime example of how FAIT, with its focus on inflation outcomes rather than forecasts, as well as the Fed's embrace of strong labor markets, can help sustain expansions. If inflation does indeed moderate this year and into the next, the Committee is likely to desist from taking policy into restrictive territory. This is another reason to remain constructive on the outlook.

Conclusion

To be clear, the current inflation environment is far from benign, and inflation will remain a good deal above the central bank's two percent objective this year. Rising rents and home prices mean that shelter inflation will contribute meaningfully to inflation. High energy and food prices will also reduce household spending power. And for the time being, wage growth remains strong, especially in service sectors struggling to attract workers. The Fed's ability to balance inflation risks with maximum employment remains to be seen. It will require a commitment to counter inflation pressure as well as an ability to pivot quickly once those pressures abate. The flattening of the Treasury curve reflects the risk that the central bank may struggle to walk this line and avoid a recession.

But inflation is still likely to moderate as the year progresses, as supply and demand for both goods and labor get closer to balance. And even as the labor market remains tight, the Fed is less likely than in the past to trigger a recession by raising rates too much on expectations of renewed inflation. While economic growth will slow, the expansion can still have room to run.

5. The Committee's economic projections are instructive on this front. In their December projections, the median participant projected a federal funds rate of just 2.1 percent in 2024, despite median projections of a tight labor market and inflation slightly above the two percent objective. This reflects the new strategy of not leaning against a strong labor market so long as inflation is close to the objective.
6. "Federal Reserve to review strategies, tools, and communication practices it uses to pursue its mandate of maximum employment and price stability," Board of Governors of the Federal Reserve System, 15 November 2018.

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