Current Economic Conditions

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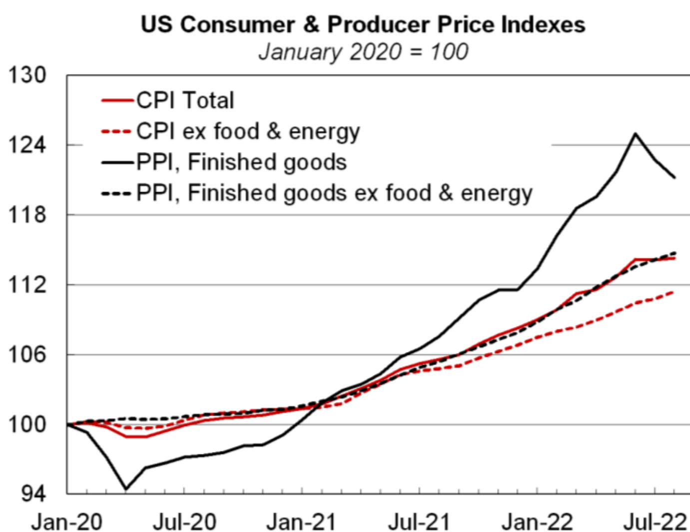
THE FED HAS MORE WORK TO DO (AND WILL DO EVEN MORE)

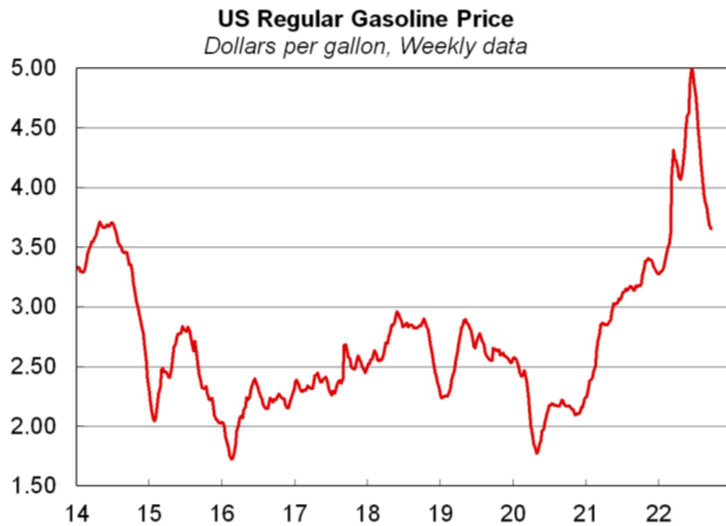
The headline U.S. Consumer Price Index rose 0.1% in August after remaining unchanged in July. This was the smallest two-month change since May 2020. On the surface, this looks like good news. But market participants expected a 0.1% decline. Prices for gasoline and fuel oil fell sharply, but except for a smaller-than-expected decline in used-car prices, other prices rose sharply. The "core" CPI, which excludes food and energy prices, rose 0.6%, versus expectations of a 0.3% increase. The stock market reacted by falling sharply; the Dow Jones Industrial Average fell 1276 points, its biggest decline since June 2020. The Producer Price Index for finished goods ex food and energy, my favorite measure of underlying inflation, was released the next day. It was up 0.5% in August. The good news is that this was the smallest increase in a year and was the fourth straight that was smaller than the prior month's increase. The bad news is that this is still 6.0% at an annual rate, totally inconsistent with the Federal Reserve's 2% target for inflation, as measured by the Personal Consumption Expenditures price index.



Stock prices fell in response to higher-than-expected inflation because investors realized that the Fed was going to have to raise interest rates more than they – the investors – had expected. Many had been holding out hopes that the Fed would only raise its target federal funds rate by half a percentage point (50 basis points) at its meeting this week, rather than by 75 basis points for a third straight meeting. The hot inflation report made them realize that 50 basis points was now off the table, and a hike of a full percentage point was now a possibility. More important, they realized that the Fed would ultimately have to raise the federal funds rate to 4% or higher. Comments from Fed Chair Jerome Powell and other Fed officials were already pointing to a 75 basis-point increase in September and a terminal rate close to 4%, but many investors chose to disregard these comments, perhaps believing that signs of slowing growth would cause the Fed to slow the pace of rate increases.

Labor market data suggests the economy isn't slowing nearly as much or as quickly as these investors believed. Payroll employment rose by 315,000 in August. Civilian employment, which seemed to have peaked in March, rose 442,000 to a new cyclical high. The labor market has remained strong into September. Initial claims for unemployment insurance, the best weekly measure of economic activity, fell to 213,000 in the week ending September 10, the lowest since May. Retail sales rose 0.3% in August. It was a small increase, but it outstripped inflation and exceeded expectations of a small decline. Industrial production in U.S. manufacturing rose 0.1%. (Total industrial production was down 0.1% because of a weather-related decline in utility output.) These data should vanquish any thoughts that the U.S. economy peaked before September. However, building permits for single-family homes, a reliable leading indicator, fell for a sixth straight month in August and are signaling that the economy will soon fall into a recession.

While commonly used price indexes suggest that inflation remains stubbornly high, there is much evidence of falling prices throughout the economy. The average price of regular gasoline has fallen from $5.01/gallon in mid-June to $3.65/gallon last week. Freight rates (for ocean shipping and trucking) have plummeted. Prices of iron, copper, and lumber have fallen sharply. House prices have turned down. Rent increases have slowed, and there's even some anecdotal evidence that rents are starting to roll over. However, as I've noted before, commonly used price indexes reflect reality with a considerable lag. This is especially true of the rent and owners' equivalent rent components of the CPI and the PCE price index. Because the Fed follows and targets inflation measures that lag reality, they were a year late in hiking rates and will probably raise them too much (and hold them too high for too long) in late 2022 and 2023.



Higher interest rates will eventually push the economy into a recession, most likely in early 2023. The impact will fall disproportionately on the housing sector and on industries tied to housing construction and home sales, e.g., building materials, furniture, appliances, floor coverings. Historically, motor vehicle sales have also been sensitive to interest rates, but auto-company finance rates have become a tool to manage sales and have been somewhat divorced from market interest rates. Also, motor vehicle sales are already at recession levels because of supply constraints. A decline in demand will have less impact on sales than in prior recessions (but will put downward pressure on prices). Business investment has never been as sensitive to interest rates as most economists believe and econometric models imply.

While I expect a mild-to-moderate recession in the United States in 2023, economic conditions are much worse in the rest of the world. The cutoff of natural gas shipments from Russia to Western Europe will force European industries to shut down this winter to leave enough natural gas to allow people to heat their homes. A desire to build inventories in anticipation of such a shutdown may explain the surprising surge in European industrial production in recent months. A decline in grain exports from Ukraine may result in dire hunger (and resultant political turmoil) in the Middle East and Africa. China is probably in a recession, although their economic data are unlikely to ever show one. A zero-COVID policy that relies on shutting down cities in response to a few COVID cases rather than on mass vaccinations will continue to hobble the economy. China's population, which was expected to peak in 2027, is already declining. (China's working-age population has been declining for several years.) Historically, China has reacted to slower economic growth by building more residential structures. That won't work very well with population down and vacancies up. More fundamentally, even though Deng Xiaoping, through his policies, lifted more people out of poverty than anyone in history, while Mao Zedong, through his policies, starved to death more people than anyone in history, President Xi Jinping has decided he would rather be Mao than Deng. That will weigh on Chinese economic growth until President Xi changes course or leaves office.

Recent data on economic activity confirm that the U.S. economy is not yet in a recession, but leading indicators continue to point to a recession starting in late 2022 or (more likely) early 2023. Chances for a soft landing have receded as persistently high inflation, as measured by commonly used price indexes, pushes the Fed to raise interest rates higher than they or the financial markets expected. Perhaps even worse, the Fed is likely to keep rates high until they see a decline in **measured** inflation, even if **timelier** data point to a more rapid decline in inflation than the Fed recognizes. As I've argued for almost a year, a recession is probably necessary to put the inflation genie back in the bottle, but because the Fed is focusing on prices indexes that lag reality, that recession might be longer and deeper than is necessary to bring inflation down to the Fed's 2% target.

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