A Delicate Balance

A soufflé is a notoriously difficult dish to prepare. Slight deviations from the recipe in terms of temperature or ingredient preparation can render a total failure. For untrained chefs, it can often be an iterative process in pursuit of the goldilocks conditions necessary to produce the puffy cuisine.

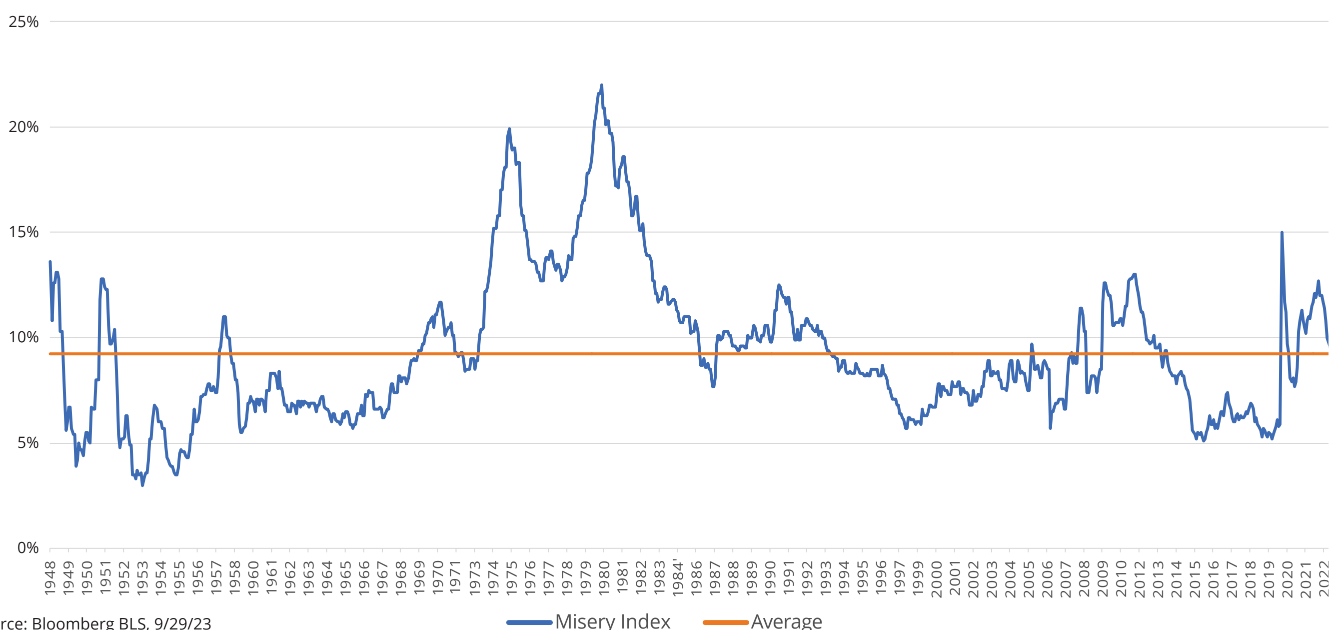
Central bankers face similar challenges in calibrating monetary policy to achieve its dual goals of minimizing unemployment while keeping inflation at bay. Even modest policy under- or overreactions to an economy's ever-evolving growth and inflation dynamic will often carry the threat of disequilibrium that creates turbulence in financial markets. Guided by economic theory, as opposed to a proven recipe, policymakers are arguably at an even bigger disadvantage than the soufflé culinarian.

One of the fundamental roles of a central bank is to smooth out a country's economic cycle through monetary policy. This is no easy task, even in the best of times. Since the establishment of the Federal Reserve Board in 1913, there have been nineteen recessions declared by the National Bureau of Economic Research (NBER). But most importantly, only one of these episodes was classified as a depression. In the 100 years prior to the existence of central banking in the US, the economy experienced four episodes of depression.

Aside from avoiding depressionary economic conditions, a simple metric of success is the Misery Index, which combines the unemployment rate with the rate of inflation. Since both high inflation and high unemployment create economic discomfort, a lower reading is most desirable.

Dating back to the late-1940's, this metric has averaged 9.3% and peaked at 21.6% in 1980. Post-pandemic, asynchronous spikes in unemployment and inflation pushed the index above average, but lately it has fallen precipitously as inflation normalizes. In a perfect world, where they get the recipe just right, the Fed would return to the low-unemployment and low-inflation regime of 2015-2019 when the index averaged just 6%.

US Misery Index

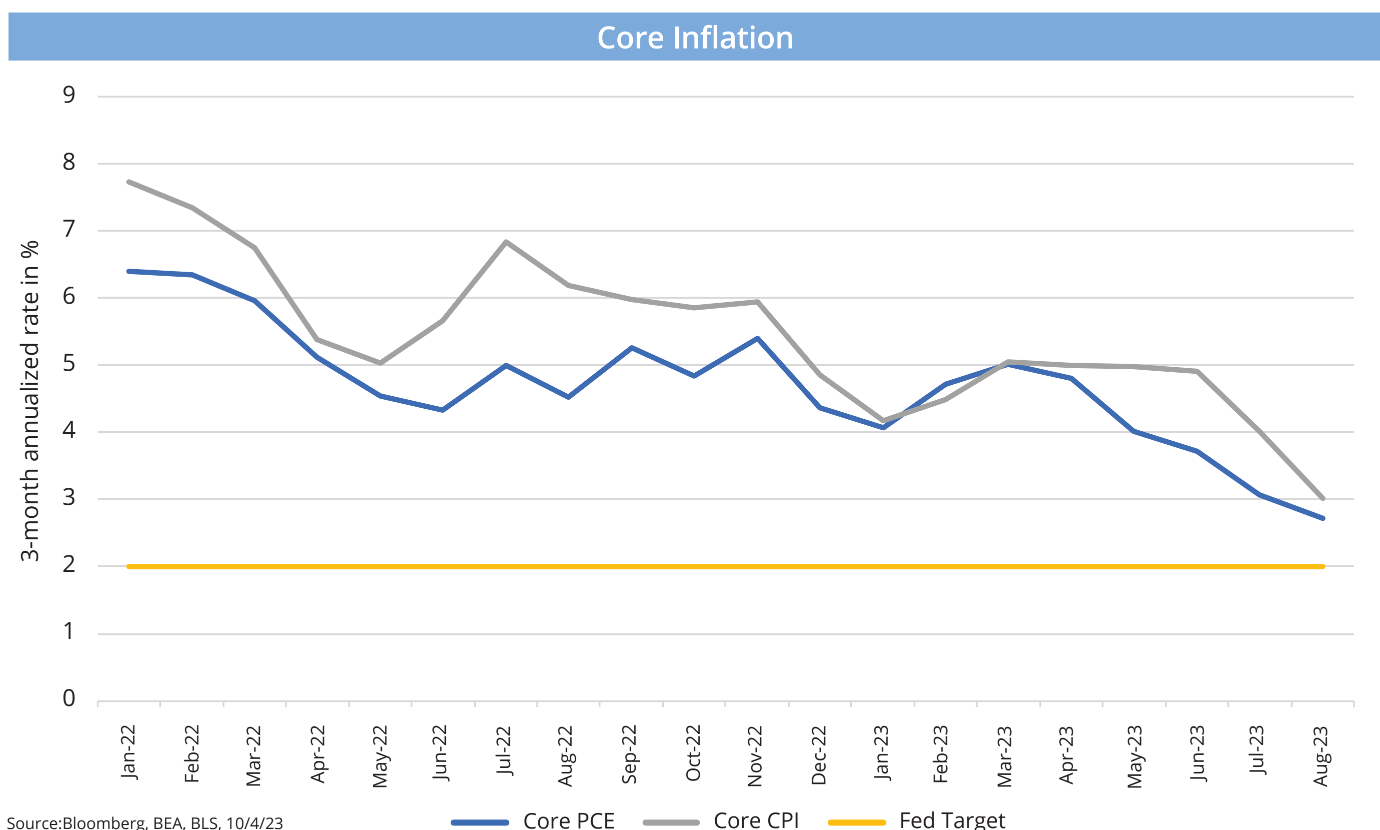


Source: Bloomberg BLS, 9/29/23

Pressure Relief

As the Fed continues its campaign to defeat inflation pressure, it must take some satisfaction in the progress it has achieved thus far. After peaking over 9% on a year-over-year basis in June of 2022, headline Consumer Price Index (CPI) registered just 3.7% for the prior 12 months through August. However, energy price fluctuations were meaningful contributors to both the rise and fall of this reading. Acknowledging the fact that monetary policy has little influence over supply-driven energy prices, the Fed prefers measures of inflation that exclude volatile food and energy prices.

In August, CPI excluding food and energy, commonly known as "Core CPI," reached 4.3% on a year-over- year basis, down from a high of 6.6% in September of last year. A close cousin of Core CPI, the Personal Consumption Expenditures Core Price Index (Core PCE), is the Fed's preferred inflation gauge and followed a similar path. With the aim of bringing Core PCE all the way back down to its stated 2% target, policymakers still have work to do on this front. However, base effects from the year-over-year calculation may mask the progress being made. Over the past three months ending in August, Core PCE has annualized at just 2.7%.



Source:Bloomberg, BEA, BLS, 10/4/23

Growing concern that the Fed will go too far (by staying hawkish too long) in its pursuit of defeating inflation has been weighing heavily on investor sentiment this year. An understanding that monetary policy works with long and variable lags is not lost on Fed Governors or investors. In Chair Powell's opening remarks at the press conference following the September FOMC meeting, he made a clear statement acknowledging as much:

> *"In determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."*

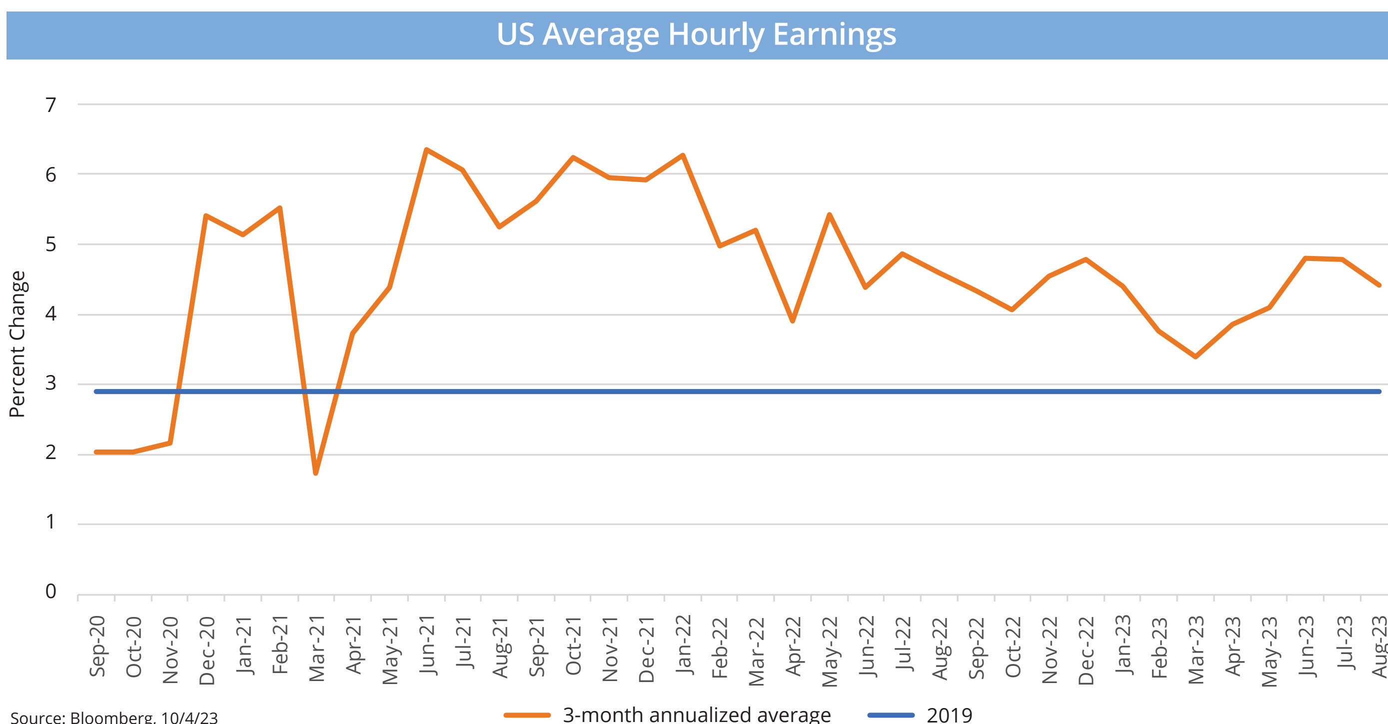
Gone For Good

The ultimate endgame for the restrictive monetary policy is not simply to get inflation back down to 2%, but to ensure it stays there. To that end, the Fed is keenly focused on the hot labor market as a potential source of kindling that could reignite the inflation fire they are so aggressively trying to put out.

While easing labor market conditions is somewhat antithetical to the other side of the Fed's dual mandate, policy makers acknowledge there can be too much of a good thing. Perhaps the most vexing development during the current rate hiking cycle has been the lack of reflexivity in the labor market. In the July FOMC press conference, Chair Powell made note of the fact that the unemployment rate was unchanged from March of 2022 when liftoff began.

This is not to say the Fed desires to put people out of work, but rather to neutralize the threat that an excessively tight labor market and the resulting wage pressure pose to stable prices. In Powell's standard opening at each post-FOMC meeting press conference of late he emphasizes: "…without price stability, we will not achieve a sustained period of strong labor market conditions that benefit all."

Subscribing to the economic theory that wage growth in excess of the inflation target plus productivity gains would be a source of demand-driven excess inflation, the Fed cannot feel as comforted with the pace at which wages are climbing. Average hourly earnings grew 4.3% over the past 12 months through August compared to 2.9% growth in 2019. Assuming productivity growth will remain consistent with the post-GFC average of 1.4%, we believe the Fed will want to see the wage growth rate fall 1% before contemplating a more dovish stance.



Source: Bloomberg, 10/4/23

With more than a century of experience under its belt, the Fed has seen many business cycles, but none that have directly comparable circumstances. Rather than relying on inapplicable economic forecasting models, policymakers will be guided by real-time data to feel their way back into the sweet spot of low inflation and low unemployment. Humility and good fortune will be essential ingredients for this recipe. For this reason, investor anxiety will remain heightened until success is within sight.

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