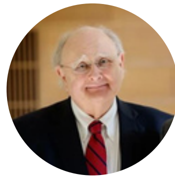
Stephens

VIEWPOINT

An Economic and Financial Commentary

July 1, 2023



By Thomas Goho, Ph.D.

The U.S. economy has encountered significant challenges following government interventions over the last three years. The measures include:

- The closing of the U.S. economy during the Covid pandemic for varying lengths of time depending on the political jurisdiction, producing almost depression-era conditions.
- The massive infusion of Federal spending sprayed across almost all sectors of the economy: households, businesses, and state and local governments.
- The large expansion of the Federal Reserve balance sheet to counteract an economic meltdown.

In the wake of these events, multi-decade high inflation emerged. The Federal Reserve is now committed to taming inflation using significant increases in interest rates as its tool to decrease inflationary pressures. Will the Fed's measures work in bringing down inflation? Will the erratic growth of the last five quarters turn into a full-blown recession? Are there pockets of economic strength that will postpone the long-predicted recession?

Four prevailing scenarios on the direction of the economy include:

- A soft landing: The first scenario is that the economy is headed into a soft landing, meaning that growth will be "weakish" probably trending toward zero but without a severe recession. Pockets of strength such as consumer spending will prevent a full-blown recession.
- A hard landing: The second view is that the economy is headed into a hard landing, meaning that the economy will go into recession. The Federal Reserve believes a recession is necessary to cool inflationary pressures, and given that the Fed controls monetary policy, a significant recession may be inevitable.
- No landing: The third scenario is that some sectors of the economy are so strong that no landing in the economy will occur. The economy will chug along at a rate of growth of around 1.5% to 2.5%.
- Stagflation: The fourth view is that the economy is headed into stagflation, meaning a combination of high inflation and real GDP close to zero for several quarters: not recessionary but very low growth of about 1% and elevated inflation as in some recent quarters.

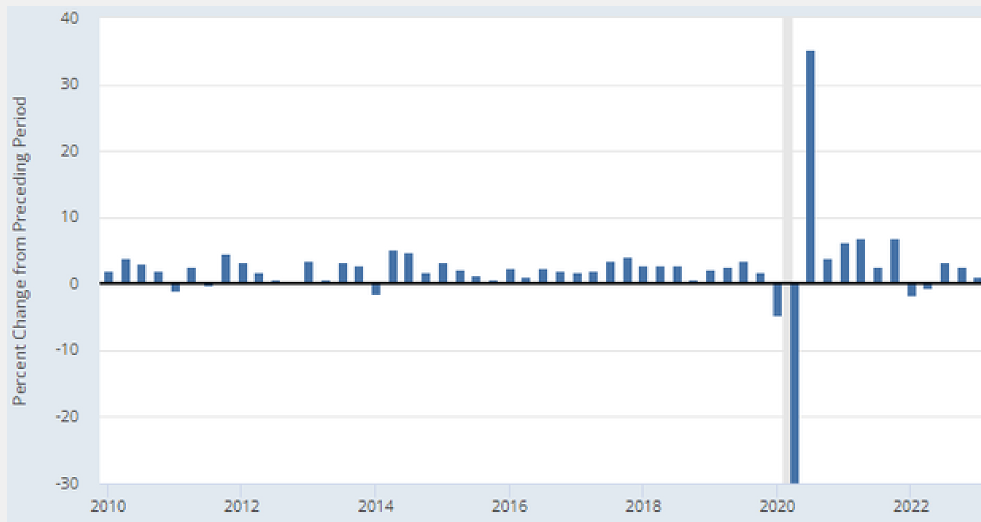
The Federal Reserve is the main player in deciding which of the four scenarios will materialize over the next 12 to 24 months.

This issue of Viewpoint examines the current and prospective conditions for the next 12 to 18 months. The focus will be on assessing the impact of Fed tightening across major areas of the economy.

Economic Growth

Several aspects of the American economy are apparent since the financial crisis of 2008-2009. First, relatively stable economic growth occurred after that crisis, with the economy growing on average about 2% per year. (See Figure 1.) Growth was largely in line with the forecasts of most governmental and private sector economists. Second, the Covid event and its aftermath were economically chaotic with the economy closing and opening in a haphazard manner. Third, the economy did not return to that slow steady 2% growth rate of the previous decade. The economy roared back (until recently) maintaining strong growth for 5 consecutive post-Covid quarters.

Figure 1: Real Gross Domestic Product 2010 to Present.



The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database June 22, 2023.

In the 5 most recent quarters, growth was either negative or slightly positive. The real GDP in the most recent quarter was 1.3%.

One indicator of the impact of the Fed's tightening policy is housing weakness. Steady Federal Reserve rate increases have already slowed parts of the economy, especially housing starts. (See Figure 2.)

Figure 2: New Privately-Owned Housing Units Started, 2020 to Present.

The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database June 22, 2023.

Housing starts decreased from 1.8 million units in April 2022 (when the Fed started tightening interest rates) to 1.6 million units in mid-2023. Higher interest rates caused many potential buyers to postpone home purchases due to higher mortgage payments. This decrease in housing starts is significant but probably not as large as the Fed would have hoped for in this early phase of interest rate increases.

On the other hand, the decrease in industrial production has been mute despite the significant increase in interest rates since early 2022. (See Figure 3.) The index of industrial activity fell from 104.5 in September 2022 to 103.0 currently. This decrease in activity is not yet signaling a recession. That recession signal occurs when the index falls below 100.

Figure 3: Industrial Production, Total Index (2020 to Present).

The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database June 22, 2023.

Best Guess About Economic Growth

There is a time-worn adage that one should not "Fight the Fed." The Fed has stated that it wants to slow the economy to tame inflation. Jerome Powell, Chairman of the Federal Reserve, recently stated that "The labor market remains tight…Reducing inflation is likely to require a period of below trend growth and some softening in labor market conditions." Short-term interest rates have increased, because of Fed policy, from close to zero to about 5%. Yet, significant softening of the economy is still not a reality judging from many economic indicators.

Given conditions in housing and industrial output along with other data points, we at Stephens think that this economy is headed toward a soft landing,

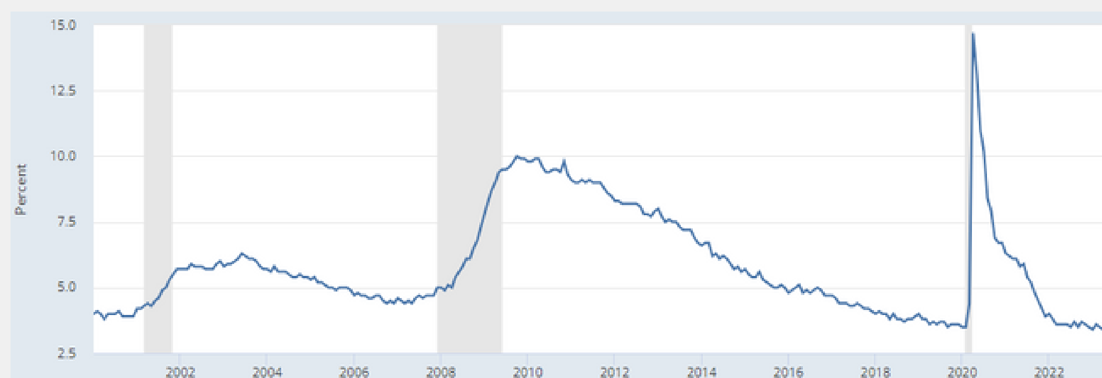
meaning growth of about zero for several quarters but not a painful recession. Many strengths remain in the economy which will lessen the likelihood of a hard economic landing. In keeping with Chairman Powell's statement, we expect "below-trend growth," and, less likely, a mild recession for several quarters. We concur with the Fed's own growth projection of .4% in 2023 and 1.2% in 2024.

Fed tightening takes between 12 and 18 months for its effects to ripple through the economy. In other words, this economy is just beginning to feel the tightened monetary policy that was initiated one year ago. Continued tightening could tip the economy into a full-blown recession. But we expected the Fed to pause its rate increases after its 10 consecutive increases. And the Fed did just that at its June meetings.

Labor Markets

Most economists agree that labor conditions are unusually robust. The unemployment rate is near a multi-decade low of 3.7% (See Figure 4.) The Federal Reserve, by initiating a policy of higher interest rates, is intent on removing some of the strength from labor markets, as Chairman Powell indicated. Less strength in labor market conditions leads inexorably to lower wage demands and ultimately lower inflation. One year in, the Fed's policy has done little to reduce labor market strength. By almost any definition, labor markets are at or near full employment.

Figure 4: U. S. Unemployment Rate, 2000 to Present.

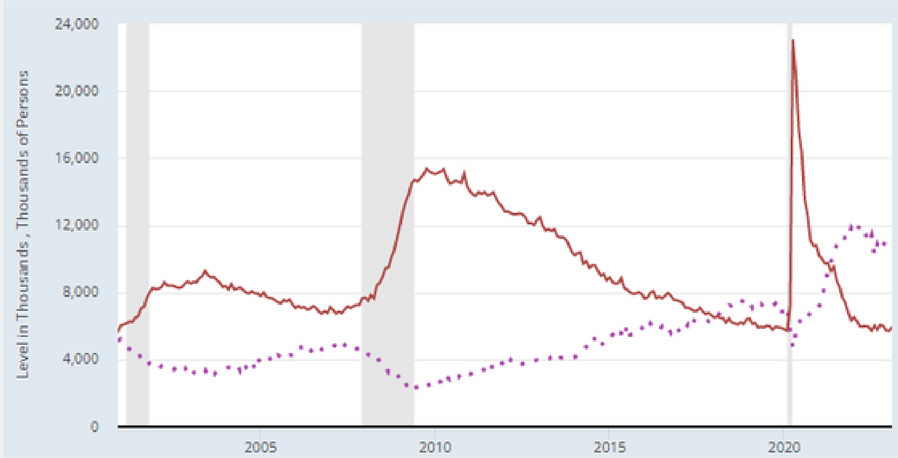


The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database June 22, 2023.

Throughout most of the first two decades of the 21st century, unemployed individuals in the labor force outnumbered job openings. However, since the end of Covid there are almost twice as many job openings as there are unemployed workers: 9.6 million job openings versus 5.9 million unemployed individuals. (See Figure 5.) Over the first 18 years of this century, this excess ratio of job openings to job seekers was extremely unusual.

Figure 5: Total Private Sector Job Openings (dotted line) and Total Number of Unemployed Persons (solid line), 2000 to Present. In thousands of Persons.



The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database June 2, 2023.

The goal of Federal Reserve policy is to significantly alter the current imbalance through monetary tightening. Its stated goal is to raise the rate of unemployment to above 4% for the next several years. (See Figure 6.) Interest rates increases should slow demand for labor. In other words, the Fed would like to take pressure off wage demands, thereby helping to decrease inflationary pressures in the economy.

Figure 6: Federal Reserve Board Members and Federal Reserve Bank Presidents Projections of U.S. Unemployment Rate, Median Estimate. Forecast Made in December 2022.

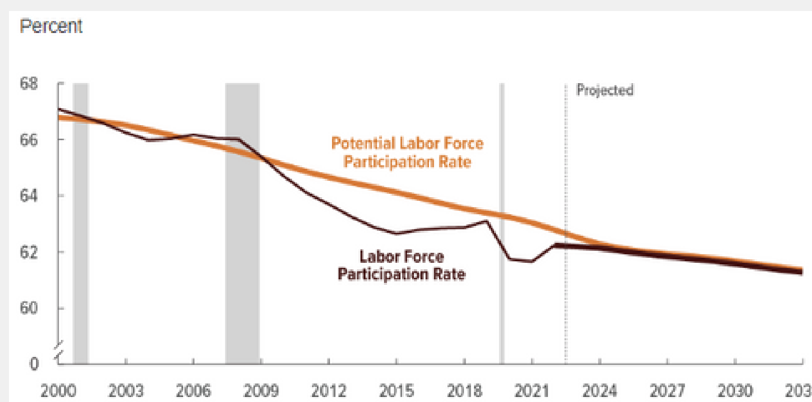
Year	Unemployment Rate
2023	4.5%
2024	4.6
2025	4.6
Longer run	4.0

Source: Federal Reserve Board. Economic Projections from the March 22, 2023 meeting.

The Fed's tightening policies so far have underperformed its expectations. Even after raising its target interest rate from close to zero to over 5%, low unemployment of 3.7% is still embedded in the American economy. There is an acute shortage of workers according to surveys of American businesses of all sizes and in most industries.

This shortage of workers can be explained in part by the labor market paroxysms during and after the Covid crisis. In addition, the shortage of workers has resulted from the inexorable drop in long-term labor participation. (See Figure 7.) As the labor force ages, it is natural to expect that older workers will be retiring. Recently, American workers are participating in work at a rate significantly lower than the potential size of the U.S. labor force.

Figure 7: Historical and Projected U.S. Labor Participation Rates, 2000 to 2033.



The shaded area indicates recession.

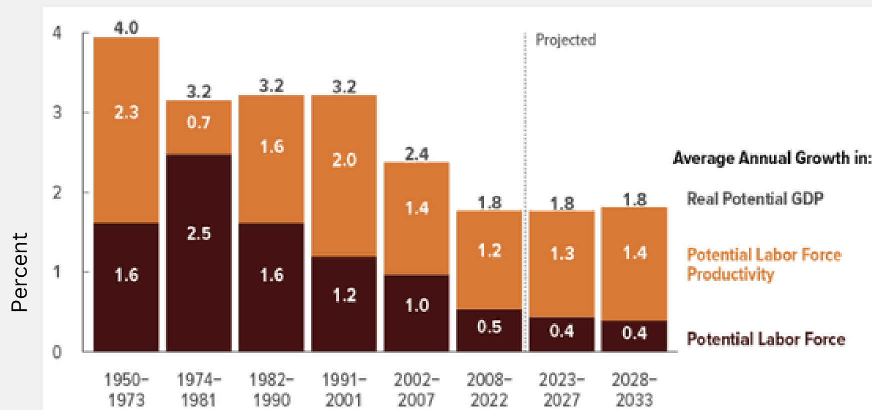
Source: U.S. Congressional Budget Office. "The Economic Outlook for 2023 to 2033." February 2023.

In other words, the potential rate of participation is decreasing, but also the actual labor participation rate in recent years is lower than the potential. This underperformance is different than in the first decade of the 21st century where the potential versus actual labor participation rates were in alignment with each other.

The labor situation is unlikely to improve if Congressional Budget Office (CBO) projections are accurate. The CBO expects labor force contribution to economic growth to be minimal between now and 2033. (See Figure 8.) At the end of the last century, growth in the potential labor force was adding between 1.0% and 2.5% to potential U.S. economic growth. Since 2008 and

projecting out to 2033, potential labor force growth will be 0.5% or less. This low labor force growth is due largely to the low birth rates in previous decades.

Figure 8: Growth of Real Potential Gross Domestic Product and Its Components.



The shaded area indicates recession.

Source: U.S. Congressional Budget Office. "The Economic Outlook for 2023 to 2033." February 2023.

A slow-growing labor force means that most of the American economic growth will have to come from enhanced workers productivity rather than from more workers. The situation is quite unlike the conditions in the second half of the 20th century when economic growth came from many more workers as well as strong productivity growth.

Best Guess About Labor Market Conditions

The Federal Reserve's desire to raise the current rate of unemployment from 3.7% to 4.6% or higher creates a fraught situation for several reasons:

- A huge demand for labor relative to the current supply of unemployed or under-employed individuals.
- A short-term and long-term trend toward lower labor participation by the American workforce.
- A small yearly increment to the total labor force resulting from the slow growth of the U.S. population.

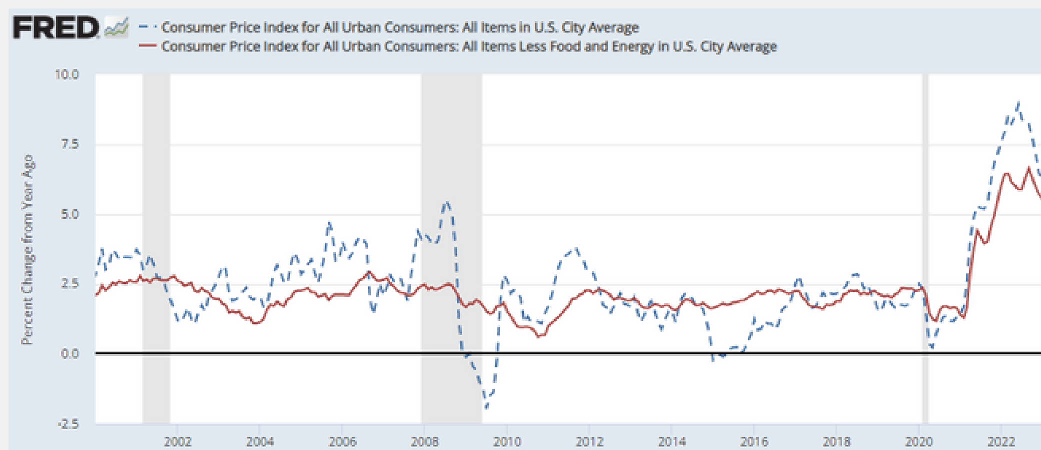
Our best guess is the Fed decision makers will have to slowly impose a tighter money policy for a longer period than they currently anticipate.

We expect that the unemployment rate is unlikely to go above 4% to 4.25% between now and mid-2024. This rate is near full employment: not likely to reduce labor demands for higher wages and benefits.

Inflation and Interest Rates

The Fed itself was the primary instrument for creating the highest inflation rates in the last four decades. Now, lower growth combined with higher unemployment is the Fed's main goal for fixing its inflation problem.
Is America experiencing runaway inflation? No. Are we experiencing unacceptable inflation relative to the standards of most major central banks? Yes. Most central banks in highly developed countries set an inflation target of about 2%. The U.S. inflation rate is now almost 5% as measured by the Consumer Price Index (CPI), which removes the volatile items of food and energy, i.e., the core CPI. (See Figure 9.)

Figure 9: Consumer Prices for Urban Consumer: All Items (dash line) and All Items Less Food and Energy (solid line), 2000 to Present.



The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database May 14, 2023.

How did the United States end up in this inflationary morass? There are at least four elements that produced the current situation.

1. The Federal Reserve spent more than a decade expanding its balance sheet purchasing U.S. government Treasury debt as well as mortgage-backed securities. It acted as though the great financial crisis of 2008-9 was unending. It kept interest rates far below the rate that most economists and analysts understood to be normal interest rate conditions.

2. When the Covid epidemic hit, it pulled out its playbook from the earlier financial crisis and accelerated its purchase of government debt and mortgage-backed securities thereby continuing its policy of inordinately low interest rates.

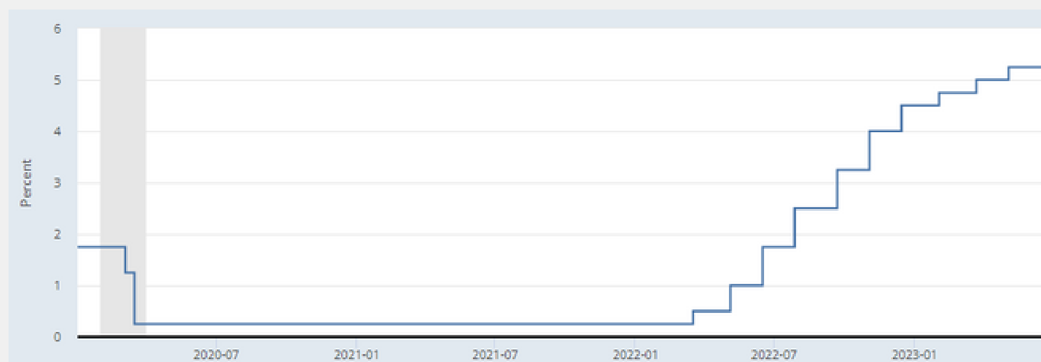
3. When high inflation developed, the Federal Reserve insisted that the inflation problem was transitory and would self-correct. That was a serious policy miscalculation.

4. The war in Ukraine exacerbated the inflation problem by creating major shortages in energy and grains, driving those prices up significantly, which increased global inflation rates, including America's inflation.

Most of the blame for the American inflation problem sits squarely at the feet of the Federal Reserve. But in fairness, the war in Ukraine increased the inflation's intensity for the Federal Reserve. But the Fed is now moving to correct its missteps and faulty decision-making over the past decade.

The Fed has finally acted appropriately, if late, in its rapid increase in target short-term interest rates. (See Figure 10.) These rate increases were decisive and necessary to decrease inflationary pressures in the economy.

Figure 10: Federal Rates Target Short-Term Interest Rate, Upper Range. 2020 to Present.



The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database June 23, 2023.

In addition to increasing short-term interest rates, the Federal Reserve is slowly, if erratically, shrinking the size of its investment in U.S. government debt and mortgage-backed securities. This move has increased long-term

interest rates, slowing spending in housing and other sectors dependent on long-term borrowing.

The decrease in housing activity, noted above, is primarily the result of prudent Federal Reserve actions since early 2022. Long-term mortgage rates have increased significantly thereby increasing interest payments for prospective home buyers. In other words, housing has become less affordable for many home purchasers. (See Figure 11.)

Figure 11: 30-Year Fixed Rate Mortgage Average in the United States, 2019 to Present.

The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database June 23, 2023.

The upshot of the Federal Reserve's actions is that inflation is slowly abating. The Fed's preferred measure of inflation is the Personal Consumption Expenditures Price Index (PCE), excluding food and energy. The PCE is still elevated, but it is down since the Fed initiated its interest rate increases in early 2022. (See Figure 12.) The PCE inflation peaked in early 2022 at 5.4%, and it is currently 4.7%.

Figure 12: Personal Consumption Expenditures Price Index, Excluding Food and Energy, 2019 to Present.

The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database June 23, 2023.

Consumer prices really haven't come down very much given the rather sharp increase in interest rates. One reason for the slow progress is that 80% of the economy is made up of services rather than goods such as housing and automobiles. Given that the service sector generally has low capital requirements, the service sector is less sensitive to higher interest rates, unlike housing.

The Federal Reserve is thus fighting a very difficult inflation battle. Service prices are sticky, and those prices have jumped and have stayed elevated. (See Figure 13.) Most consumers have experienced price increases for services like yoga classes, dog grooming, doctor's visits, Uber rides, car insurance premiums and a range of other service prices.

Figure 13: Consumer Price Index for All Urban Consumers: Services Less Energy Services in U.S. City Average, 2006 to Present.

The shaded area indicates recession.

Source: Federal Reserve Bank of St. Louis. Federal Reserve Economic Data (FRED), Extracted from database June 23, 2023.

Federal Reserve policy has begun to work in the housing and a few capital-intensive sectors of the American economy, but its job is still incomplete in the service sector. As Raphael Bostic, President of the Atlanta Federal Reserve Bank, noted in late 2022, "We will need to see increases in services prices slow. So far, we haven't." Significant service price easing is still not evident in mid-2023. Given that services represent about 80% of the economy, there is still much more work to be done by the Fed.

Best Guess About Inflation and Interest Rates

We at Stephens expect that inflation will remain above the Fed's target of 2% for longer than the Federal Reserve and market participants expect. This inflation battle will take at least until late 2024. And the Fed will need to keep interest rates elevated at least until early 2024. Most bond market participants expect that the Fed will begin lowering short-term rates by late 2023. We think that time frame is too optimistic.

Final Thoughts

We are slightly more sanguine about the economy than many forecasters. The strength in labor markets will prevent a hard landing. If a recession occurs, it will be mild in intensity and short in duration. Other forecasters are a bit less optimistic. The Conference Board put the probability of a near-term

recession at 99%, Bloomberg Survey of Economists at 70% and the National Association of Business Economics survey at 58%.

We at Stephens have made some best guesses, but our confidence level is not as resolute as we would like for several reason:

- American labor markets are unusually strong in the post-Covid world of 2023. Weakening those markets to mitigate wage pressures may be more difficult than anyone, including the Fed, can anticipate.
- The Federal Reserve, until very recently, has not demonstrated the determination to make hard, rational decisions about monetary policy.
- An erratic and/or continuing banking crisis could weaken the Fed's resolve to fix the U.S. inflation problem.

Chairman Powell of the Fed is like a quarterback with a minute left on the clock who throws the ball two feet over the head of a wide-open receiver at the goal line. A real blunder. It's now the fourth down, and he has one more chance. The fans are unsure if he is made of the "right stuff" to score the touchdown. But we are all still hopeful that we will make it over the goal line.

Thomas Goho, Ph.D. is an Economic Contributor for Stephens Inc. He also served as the Co-Director of Stephens University at Wake Forest University.