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Fed Thoughts: Suspension of Disbelief

Vincent Reinhart | Chief Economist & Macro Strategist

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In the waning, steamy days of July, the economic calendar was full, if not the office buildings in financial centers. For those who stuck around, there were the last data pieces of the economic puzzle for the second quarter, quarterly earnings reports for the bulk of the firms comprising the S&P 500®, and the fifth meeting of 2022 of the monetary-policy-setting group of the Federal Reserve (Fed). Whether that information sunk in is less obvious to us. Rather, we feel the interpretation of events was mostly shoe-horned to fit the prevailing policy narrative, both inside the Fed and apparently among market participants. Good news was good; bad news had the silver lining of foretelling a rebound. The result followed the storyline that the Fed would hew to its established policy path, slowing the growth of aggregate demand, perhaps at the risk of a shallow recession next year with few untoward consequences, and successfully return inflation to its longer-term goal. We believe this happy coincidence of events would allow the Fed to reverse course and ease next year. There is a glow about it, as in the opening pages of a fairy tale with a sunlit castle and a happy family.

Here, we provide a bracing reminder that summer romances do not usually last but, instead, are followed by a discontented Fall and cold Winter. For now, there is a mutual suspension of disbelief among officials and market participants of the old, hard logic of the business cycle. We think reality will set in, and a happy ending is only afforded to investors prepared for it now. We proceed first with the facts, next voice our doubts, and then pose three uncomfortable questions about the outlook.

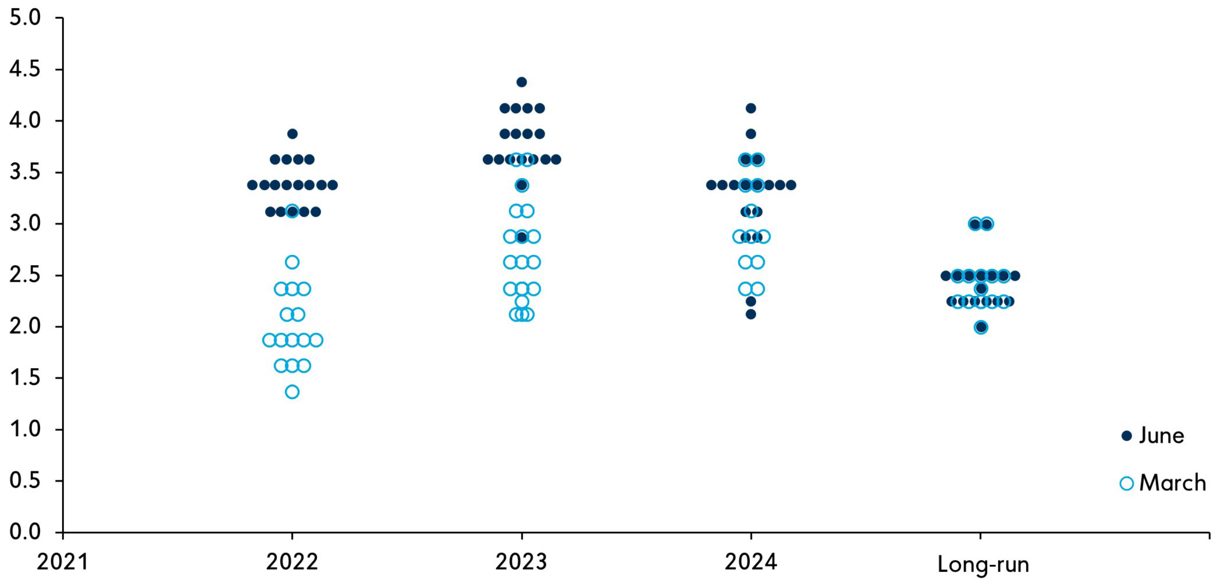
The Fed delivered as expected at the July 26-27 meeting of its Federal Open Market Committee (FOMC), raising the policy rate 75 basis points and assuring that ongoing increases would be appropriate. Although Chair Powell offered the usual disclaimers at his subsequent press conference that elevated economic uncertainty made rate guidance of dubious value, he appeared relatively confident that the policy plan outlined in the Summary of Economic Projections (SEP, below) from the prior meeting still held, was priced in by financial market participants, and would deliver disinflation. While firming the policy rate raised the risk of an economic downturn, the chair held that the economy was not currently in recession and that there was a path where one would be avoided. Even if there were one, it would be aseptic as the risks to financial stability were limited.

Economic Projections of Federal Reserve Board Members and Bank Presidents
Percent

	2022	2023	2024	Longer Run
Change in Real GDP	**1.7**	**1.7**	**1.9**	**1.8**
March Projection	2.8	2.2	2.0	1.8
Unemployment Rate	**3.7**	**3.9**	**4.1**	**4.0**
March Projection	3.5	3.5	3.6	4.0
PCE Inflation	**5.2**	**2.6**	**2.2**	**2.0**
March Projection	4.3	2.7	2.3	2.0
Memo: Projected Appropriate Policy Path				
Federal Funds Rate	**3.4**	**3.8**	**3.4**	**2.5**
March Projection	1.9	2.8	2.8	2.4

Source: Federal Reserve, accessed 6/15/2022 at https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20220615.htm.

Appropriate Fed Funds Rate at Quarter End
Percent



Source: Federal Reserve, accessed 6/15/2022 at https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20220615.htm.

We believe this confidence is difficult to square with circumstances. The Fed forecasts inflation to fall over the next year even as the policy rate remains negative in real terms and the unemployment rate runs below its own assessment of its natural rate (an assessment that Chair Powell speculated may be too low at his press conference, implying an even wider gap). This disinflation optimism limits both the necessary projected hikes in the policy rate and adverse fallout to economic activity. It hinges on forces materializing—increased aggregate supply as people return to the labor force and global supply chains mend—that failed to materialize last fall when the Fed was similarly optimistic about imminent disinflation working from a lower base inflation rate.

This implicit optimism propositions that:

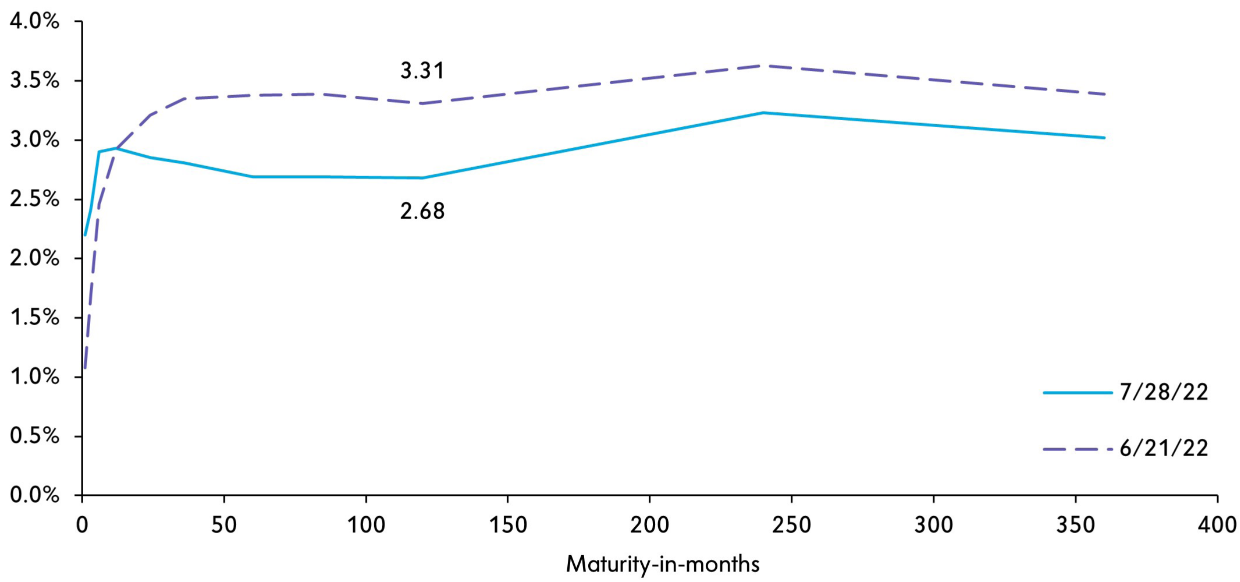
- High inflation is not stubborn
- Aggregate supply fills in seamlessly after significant disruptions
- Policy-induced slowing avoids tipping the economy into recession
- Recessions are not messy
- Monetary policy promptly and reliably turns on the first sign of weakness in activity even when inflation is high

These each individually find almost no historical support, let alone as a divine coincidence. Moreover, we believe the Fed narrative is founded on an internal inconsistency: As long as market participants believe it, financial conditions will not tighten to support its precondition that aggregate demand growth continues to slow.

The road map of that inconsistency is shown in Treasury yields, plotted below (on the vertical axis) for selected maturities (in months along the horizontal axis) for the market closes after the past two FOMC meetings. Interest rates at shorter maturities are up materially, consistent with two ¾-percentage-point hikes in the Fed's overnight policy rate at those meetings, but the nominal ten-year yield fell ½ percentage point. The ten-year maturity is the fulcrum of the Fed's policy lever, as it shapes rate-sensitive spending decisions and the present value of capital assets. What it does not show is a tightening of financial conditions that would crimp the expansion of aggregate demand.

Treasury Yields by Maturity

Constant maturity, percent



Source: Federal Reserve, accessed via FRED on 7/29/2022.

We believe Fed officials will have to do something hard when inflation fails to fall immaculately—raise the policy rate sufficiently enough to tighten financial conditions to slow the growth of aggregate demand to bring it into better alignment with the level of aggregate supply. We feel only then can inflation be brought down following the harsh rules of the business cycle.

Working against them is catch-up in business costs as people attempt to recoup lost purchasing power, the need for firms to pay-up for scarce workers, and the creep-up of the public's expectation of inflation, which feed into cost and price pressures. Swinging from a major impediment to a major benefit—sometime soon but not as soon or as much as Fed officials hope—is an improvement in aggregate supply, as global supply chains mend and health hesitancy lifts. Russian adventurism on the ground in Eastern Europe and in energy and other commodity markets, as well as the hardening of the wall of global sanctions and opprobrium among the nations that have chosen sides in the Ukrainian conflict, will slow the former process. As for the latter, we believe the ability of the coronavirus to mutate beyond the protections of immunization and natural immunity makes it likely that concerns about personal health and lockdowns in the world's second-largest economy linger.

If luck does not fully favor the Fed, which is usually the way to bet in our view, it will have to revisit its inflation forecast by early next year and admit that the current SEP represents a lower bound on the path of interest rates.

The situation would be made even more problematic if market participants come to that view before the Fed, un-anchoring their inflation expectations.

Chair Powell flagged two points at this press conference underscoring that a mid-course correction will be increasingly difficult the longer the Fed waits.

For one, the FOMC will go in the other direction of ratcheting up restraint by slowing the pace of policy hiking sometime soon. Powell explained the arithmetic as follows: If the SEP dot plot is a reasonable depiction of the path of rates over the remainder of the year, then there is about 100 basis points of firming to spread over the next three meetings. The near-term practical implication is to expect talk in coming weeks of a downshift to a 50-basis-point action at the September meeting (an intermeeting period that includes the chair's appearance at the Jackson Hole Symposium). The longer-term problem is that such a precedent may make Fed officials reluctant to pick up the pace of firming later.

For another, the SEP dot plot indicates both the desired direction of the policy rate and the increasing disagreement among FOMC participants about its level. Moving the policy rate off its zero floor gradually allowed the FOMC easy wins early in the process, in that all members could agree that the policy rate was too low. Now that the rate is 2 ¼ to 2 ½ percentage points higher, as Chair Powell noted, it might be viewed as around its neutral level (in nominal if not in the real, inflation-adjusted, terms that matter as will be discussed later), and disagreement will emerge as to how much overshooting will be required. Those FOMC participants toward the lower part of the cloud of dots in the SEP might be reluctant to shift them up as quickly as necessary, especially as inflation falls below its peak and the unemployment rate rises.

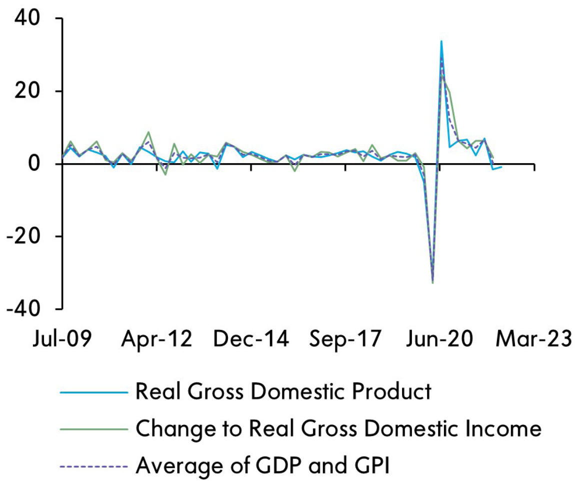
Three questions are pertinent to the outlook because, as the answers become clearer, so too will the current disconnect in market sentiment.

Are we there (in recession) yet?

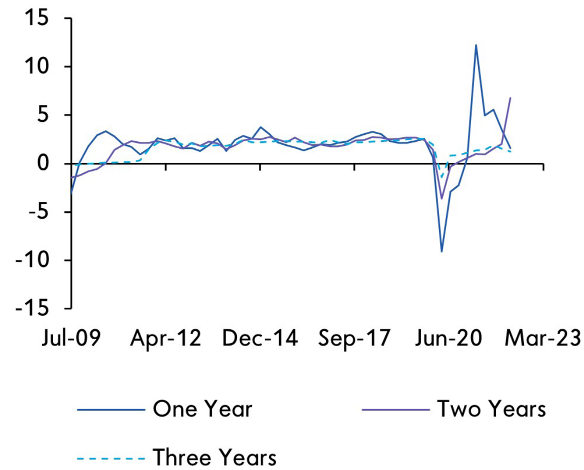
As an example of the pitfalls of real-time economic analysis, Fed Chair Jay Powell confidently declared "I do not think the US is currently in recession" at his press conference.[1] About 18 hours later, the Bureau of Economic Analysis (BEA) published real GDP for the second quarter of 2022, which posted a second consecutive decline. True, two negative quarters in the change in real GDP in a row only crosses a journalist's definition of a recession, not that of the arbiters of the business cycle at the National Bureau of Economic Research (NBER). But that has not stopped the 16th chair of the Federal Reserve System from becoming an internet meme.

Putting too much weight on one economic time series is never a good strategy, especially considering that the BEA reports that the average subsequent revision of GDP (regardless of sign) is around ½ percent. Economic activity is measured from different data systems in terms of spending, income and output. As in the chart, the average of the first two, gross domestic product (GDP) and gross domestic income (GDI), is thought to be a more reliable reading than the two individually. Through the first quarter (GDI is reported with a one-release-date lag), the average was flat, not down. Smoothing over time, GDP over the past one, two, and three years is still expanding above trend.

Real Gross Domestic Product and Income
Quarterly change, percent annual rate



GDP, One-, Two, and Three-Year Averages
Percent, annual rate



Alternative Indicators of Economic Activity Favored by the NBER Dating Committee Average annual growth, first half 2022, percent	
Real personal income excluding current transfer receipts	**0.1**
Employment Level	
Total nonfarm, establishment survey	3.7
Total, household survey	2.8
Real Personal Consumption Expenditures	**3.6**
Advance Retail Sales: Retail Trade in real terms	**3.8**
Industrial Production: Total Index	**5.3**

Source: Bureaus of Economic Analysis (GDP, GDI, consumption, and income) and of Labor Statistics (employment) and Federal Reserve (IP), accessed via FRED, 8/1/2022.

The Dating Committee of the NBER provides its dated calls of recession based on downturns of activity that are deep, diffuse through the economy, and of some duration (the three D's of business-cycle analysis). The key monthly indicators (the determination is to the calendar month) they rely upon were still mostly expanding strongly over the first half of the year, as in the table. Most of them were performing, as Powell related, "too well" to be consistent with recession. While we are not there yet, there are three qualifications to keep in mind.

First, data are subject to revision, and revisions are two sided. The pothole in GDP may be subsequently smoothed away or other parts of activity may be revised down to show a more diffused contraction.

Second, economic data can sometimes move sharply in a nonlinear fashion, perhaps to bely the steady expansion seen thus far this year. Hiring patterns, for instance, may have been influenced by the widespread pandemic-related disruptions making it difficult for firms to attract and retain workers. Firms might smooth through some weakness in the demands for their products to get workers when they are available, hence the 3 ¾ percent gain in payrolls in the first half (at an annual rate). But hiring plans will come to a sudden stop if managers view the falloff in sales as more long lasting. The same smoothing motives may be in play in decisions by households on their spending or entrepreneurs in starting businesses.

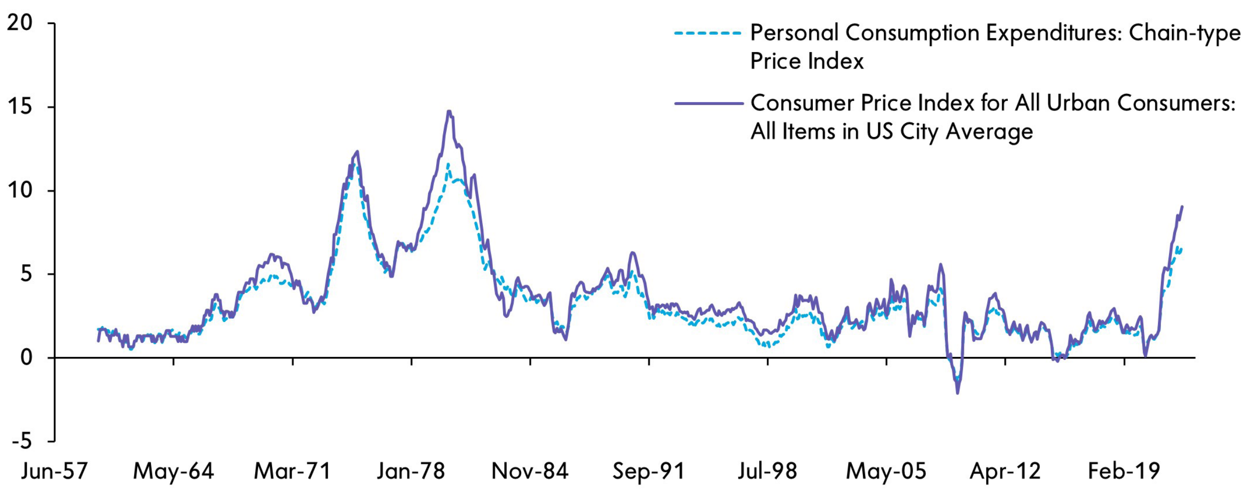
Third, given the withdrawal of fiscal stimulus and onset of Fed tightening, aggregate demand is slowing (although we do not think sufficiently to cope with the prevailing inflation problem). If activity veers into contraction later in the year (as in our forecast) to satisfy the Dating Committees rule of three D's, the NBER dons may bring forward the date of the onset of recession to when GDP first turned down. That is, history may read that we are in the early days of a lengthy recession.

What is the Fed missing about cost and price pressures?

In advance of the FOMC, consumer prices for June showed inflation was still running above 9 percent on a 12-month basis, with prices picking up across a broad swath of the household spending basket. Just after the meeting, the Fed's preferred inflation measure, using the price index for personal consumption expenditure, ticked higher to a 40-year peak.

Consumer Prices

12-month change, percent

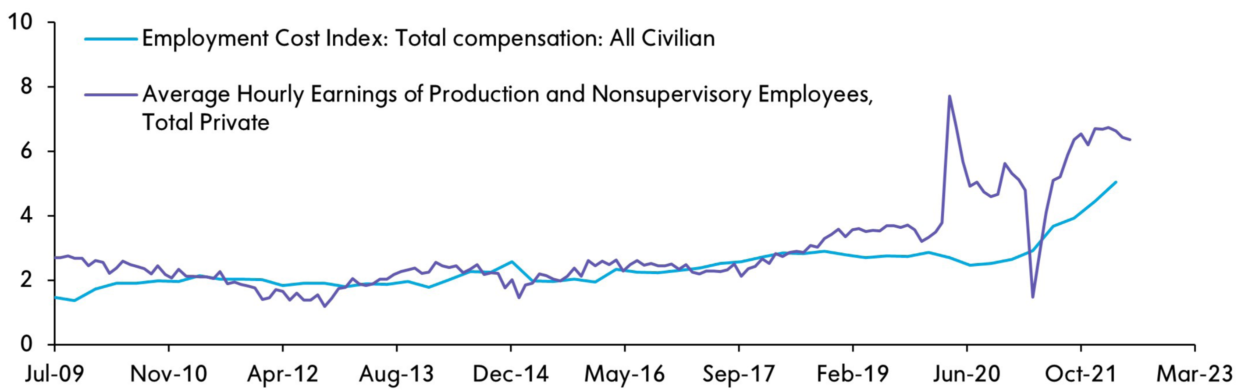


Source: Bureau of Labor Statistics, accessed via FRED, 8/1/2022.

Three distinct gears in the cost-price mechanism are gaining traction that we think will prove the unravelling of the Fed's forecast of immaculate disinflation. Workers will want to **catch-up** for their lost purchasing power after the recent surge in inflation, firms will have to **pay-up** in a labor market where job openings outstrip the available pool of unemployed, and expectations will **creep-up** as higher inflation becomes the norm.

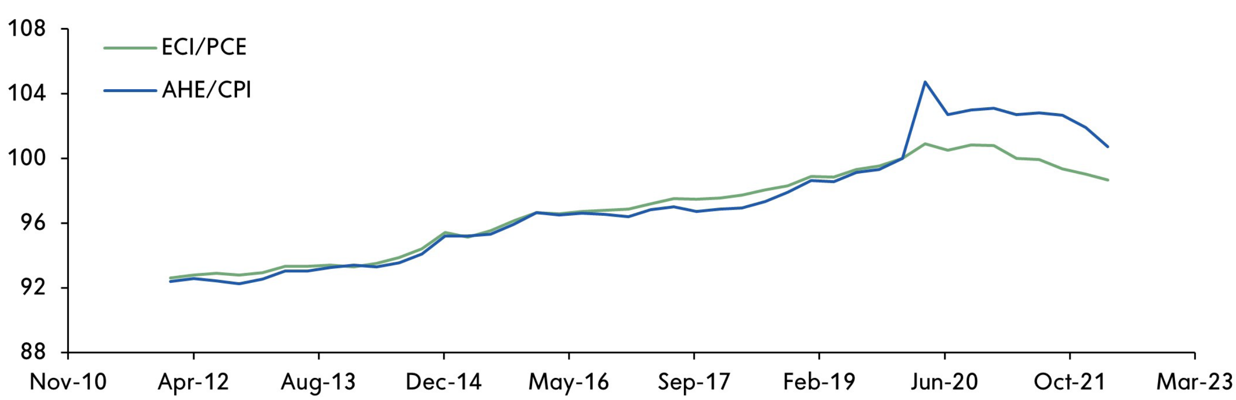
1. **Catching-up for lost purchasing power.** After the FOMC meeting, data were released for the second quarter for the Employment Cost Index (ECI), the Fed's preferred measure of labor costs. (The ECI provides a more inclusive reading than just wages with a fixed survey panel that attenuates the compositional shifts confounding average hourly earnings, AHE.) In the event, compensation growth came in better than expected by economists and seems to be closing ground on earlier increases in average hourly earnings, as in the chart. The earlier escalation of AHE was part compositional, as lower-wage workers in the service sector with fewer employment protections and more easily shed bore the brunt of the contraction in demand related to the pandemic, raising the share of higher-wage entries in the sample. Smoothing through those gyrations, both AHE and the ECI are gaining momentum. Part of the reason is that people are looking into the rearview mirror, as those earlier gains in money wages lost ground to more significant increases in consumer prices. In real terms (as in the chart adjusting AHE for the CPI and the ECI for the Fed's preferred price gauge), workers have broken even on the former and are well below on the latter relative to their pre-pandemic paydays. Both are well below than predicted from the trend of the earlier part of the period shown. Further catch-up will add to the upward momentum of costs.

Employment Cost Index and Average Hourly Earnings
One-year change, percent



Source: Bureau of Labor Statistics, accessed via FRED, 8/1/2022.

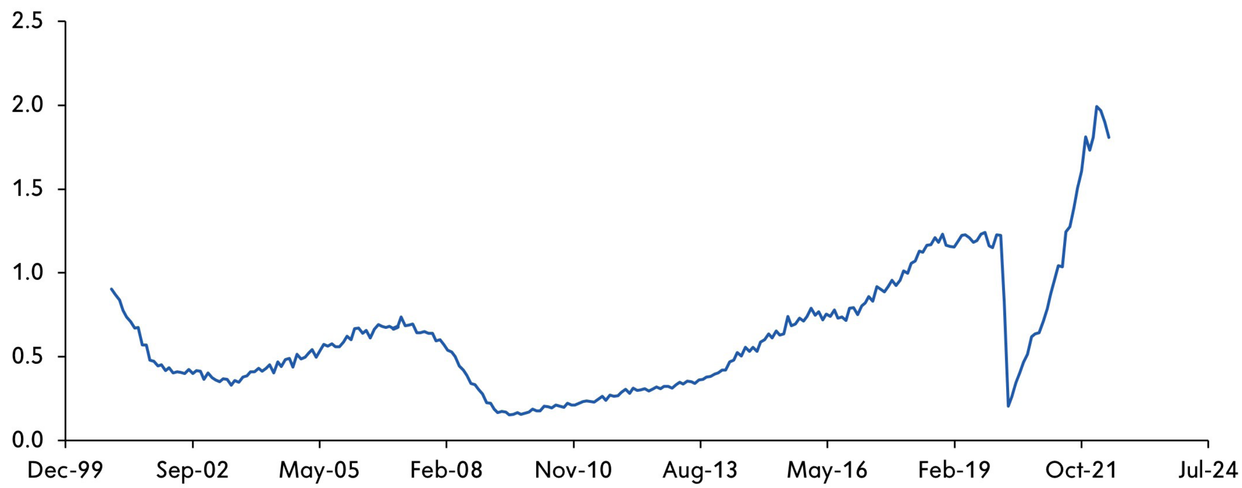
Compensation Adjusted for Purchasing Power
Index, Q1 / 2020 = 100



Source: Bureau of Labor Statistics, accessed via FRED, 8/1/2022.

2. **Paying-up for workers in a tight labor market.** At around 3 ½ percent, the unemployment rate tracks well below the Fed's own assessment of its natural rate (and even more so if Chair Powell's suspicion that the natural rate has risen is correct). This reading on labor-market pressure would suggest, by itself, that workers will be able to command higher wages in real terms. But pandemic and business-cycle disruptions to the labor market have made those pressures even more intense. Even after a soft reading in June, job openings still outstrip unemployment by a ratio of 1.8-to-1 (as in the chart). This is the reed that the Fed chair clung to in his press conference to suggest that the rules of the business cycle may not prevail as harshly as in the past. As put by Fed Governor Waller, slowing demand growth may cut into vacancies rather than lead to job separations.[2] If so, the labor market can cool without the increase in the unemployment typically associated with recession. It could happen, but it has not happened before. Rather, we share the darker assessment of Blanchard, Domash, and Summers that, relatively reliably, vacancies and unemployment move closely and negatively together.[3] That is, the test of time is that they both will jointly worsen, likely sufficiently to induce economic recession.

Job Openings in the Nonfarm Sector to Unemployment Ratio



Source: Bureau of Labor Statistics, accessed via FRED, 8/2/2022.

3. **Creeping-up expectations of inflation.** Without question, Fed officials are acutely aware that their job would become harder if the public's inflation expectations rise. In his press conference, the chair acknowledged policy restraint was necessary to prevent people from starting "…to factor higher inflation into their decisions, on a sustained basis."[1] This reassuringly goes back to the Volcker-Greenspan definition of price stability, not referring with false precision to a numerical bogy, but to avoiding a state of civic angst where people waste effort taking account of a changeable price level in their decision making. But worrying about them "starting to" is starting too late. Inflation has assuredly broken out of the 1-to-3 percent comfort zone that had prevailed for 30 years, fueling that angst as evidenced in opinion polls, internet searches, and the heated criticism of the elected class of the Fed channeling the concerns of their constituents. Measures of inflation expectations are higher, but mostly contained, so score one for Fed officialdom. But no one can be confident about how those expectations are formed or the firmness with which they are anchored. We strongly suspect that, outside the Volcker-Greenspan zone of prices stability, a terrain unfamiliar to most of this generation of policy makers and the models they rely upon, public concerns about changeable prices become more salient and their expectations less firmly grounded. That is where we are.

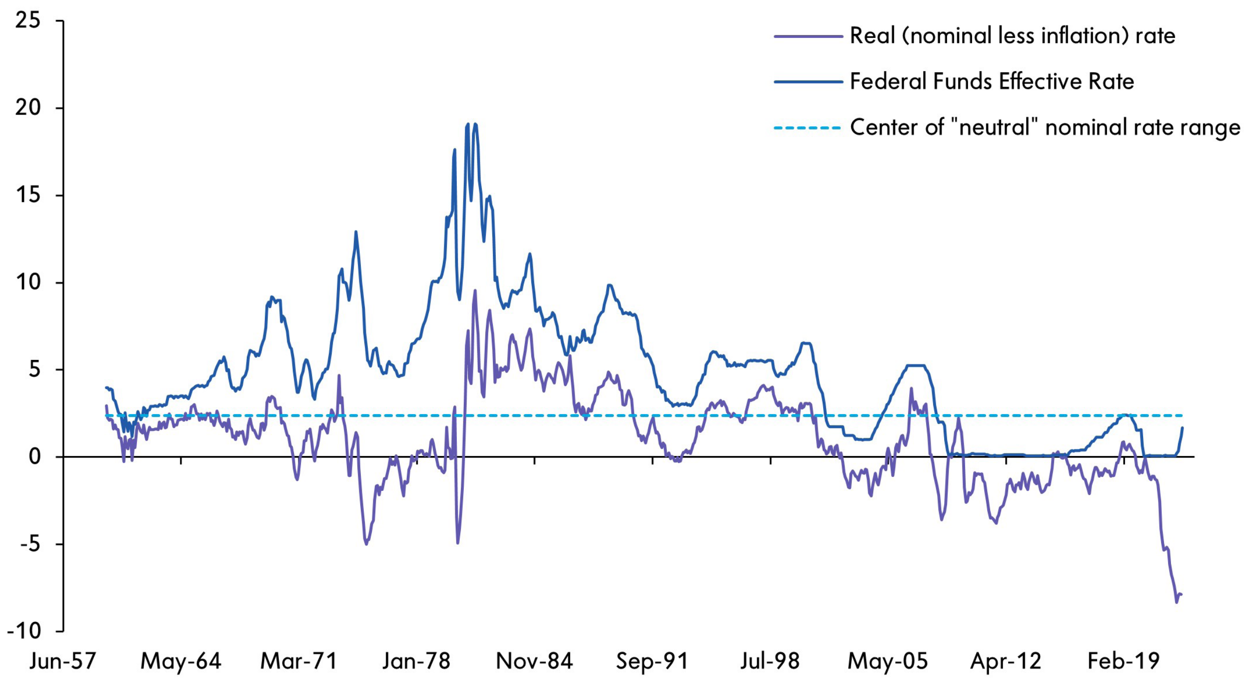
Are we there (at a neutral fed funds rate) yet?

The most baffling assertion by Chair Powell at his recent press conference was, when discussing the nominal policy rate, that "We're at 2.25 to 2.5 and that's the right range of what we think is neutral."[1] Economic decisions are almost universally described as depending on rates in real (inflation-adjusted) terms, as is the longer-run state of balance associated with neutral or natural levels of key variables. The nominal rate is residual to that process, determined by tacking on the prevailing rate of inflation to the neutral real rate.[4]

A nominal overnight rate of 2 3/8 percent (the center of that chair's range) is uncommon. As shown in the chart, there have been only three times it hit that level on the way up. On average, inflation was 3/8 percentage points higher twelve months later.[5] There is nothing neutral about that.

Nominal and Real Fed Funds Rate

Nominal and nominal less 12-month changed in CPI, percent



Source: Bureau of Labor Statistics and Federal Reserve, accessed via FRED, 8/1/2022.

The more relevant economic concept is the nominal funds rate less expected inflation (proxied in the chart by trailing 12-month consumer price inflation). In real terms, the funds rate is plumbing new depths, nowhere near the Fed's own assessment implied from the SEP that its neutral level is around positive ¼ to ½ percent. Once again, the Fed seems only informed by the pre-pandemic experience of this century, when inflation was in the Volcker-Greenspan zone of price stability and inflation was not material in the public's consciousness. We are no longer there, and monetary policy is still accommodative, not neutral, and certainly not restrictive.

The bleak summary is that the Fed is not positioned to slow the growth of aggregate demand sufficiently to reduce inflation back to its goal. As long as it believes the fairy tale of immaculate disinflation, the Fed will remain behind the curve. Indeed, to the extent that investors share the Fed's assessment of benign business-cycle dynamics, it is further behind the curve. Chair Powell was right, with one exception, in his remarks at the press conference regarding inflation:

> "If you fail to deal with it in the near term, it only raises the cost of dealing with it later. To the extent people start to see it as just part of their economic lives. They start to factor high inflation into their decisions, on a sustained basis. When that starts to really happen, and we don't think that's happened yet, but when that starts to happen, it just gets that much harder. And the pain will be that much greater. So I really do think that it's important that we address this now and get it done."[1]

We cannot give him the last word because of the critical exception in the middle. We think that the qualifier, "...we don't think that's happened yet," is dangerously optimistic. In our view, it has, and it will get worse, as will be painfully obvious over time.

Vincent Reinhart
Chief Economist & Macro Strategist

Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also worked in several roles at the Federal Reserve over 24 years, including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

Endnotes

1. Transcript of Chair Powell's Press Conference. Page 11. July 27, 2022. Found at: https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20220727.pdf
2. Waller, Christopher. Responding to High Inflation, with Some Thoughts on a Soft Landing. May 30, 2022. Found here: https://www.federalreserve.gov/newsevents/speech/waller20220530a.htm
3. Blanchard, Olivier. Bad news for the Fed from the Beveridge space. July 2022. Found here: https://www.piie.com/publications/policy-briefs/bad-news-fed-beveridge-space
4. Being baffled is a charitable assessment relative to the one offered by Larry Summers, who held that "Jay Powell said things that, to be blunt, were analytically indefensible" (https://www.bloomberg.com/news/articles/2022-07-29/summers-says-powell-s-call-on-neutral-fed-rate-indefensible#xj4y7vzkg).
5. The count is based on the funds rate rising to around 2-3/8 percent from at least ¼ percentage point lower six months earlier and averaging 12-month CPI inflation one year later over the three crossings.

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