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One Way or Another:
Inflation & the Federal Reserve

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"One way, or another, I'm gonna find ya
I'm gonna get ya, get ya, get ya, get ya."
-Blondie, 1979

Since April, Federal Reserve Chairman Jay Powell has made one thing clear: Any surge in inflation that appears as we emerge from the pandemic will be "transitory." Either price hikes triggered by reopening will abate naturally as demand normalizes and supply ramps up. Or, much like Blondie's iconic hit about a stalker that lead singer Deborah Harry endured in the 1970s, the Fed will use rate hikes to forcefully chase down inflation.

The Federal Open Market Committee (FOMC) - the policy setting arm of the Fed - has started the process of removing accommodation by tapering asset purchases; committee members will reduce their $120 billion in monthly purchases to $105 billion and $90 billion in November and December, respectively. They left the door open to accelerate the pace of tapering when they meet again in December. The Fed wanted to complete tapering before a liftoff in rates, which could occur sooner than expected.

Powell went out of his way to say he would remain "patient…[but] will not hesitate" to raise rates if inflation looks more persistent. That is where the risk lies.

This edition of ***Economic Currents*** takes a closer look at the causes of the current inflation, how the Fed will likely react to those shifts and what the actions mean for the outlook. Soft landings are tricky to engineer in the best of times when economic shifts occur at a much slower pace and the Fed is preempting instead of chasing inflation.

Economy Ends 2021 on High Note

Real GDP slowed to a 2.0% rate in the third quarter, the weakest pace in a year. Consumer spending decelerated in response to the spread of the Delta variant and acute shortages; vehicle dealer lots are still nearly empty. Housing activity contracted for the second consecutive quarter in response to skyrocketing prices and shortages of building materials and skilled carpenters. Business investment contracted when manufacturers were unable to get the computer chips needed to produce and upgrade equipment. Inventories were rebuilt but remain sparse. The trade deficit widened as exports fell in response to weakness abroad and rising imports. Government spending essentially flatlined.

Real GDP is forecast to rise 4.4% in the fourth quarter, more than twice the pace of the third. Spending on travel and medical procedures delayed during the height of infections is picking up, while our borders have reopened to wealthy foreign tourists. Housing remains constrained by sky-high prices and widespread shortages. Durable goods orders show a rebound in business investment, while inventories are expected to continue to be replenished. Government spending is expected to regain momentum, while the trade deficit is expected to narrow.

The resurgence in demand will spur inflation, which is likely to test new pandemic highs in the fourth quarter. The CPI could come close to 6% on a year-over-year basis during the last three months of the year, the fastest pace since the height of the Gulf War in 1991.

The chance of a misstep is rising, given how fast the economy is shifting. Forecasting during the global financial crisis was like standing on a fault line; forecasting during the pandemic is more akin to standing on quicksand, where the shifts are rapid and unforgiving.

We have two scenarios. Our base case shows a more patient Federal Reserve waiting for a full recovery in employment before raising rates in the second half of 2022. The second has the Fed chasing down inflation with more aggressive rate hikes, something it hasn't done since the 1980s; it does not end well.

Boom/Bust

2 Scenarios

Chart 1 shows the two scenarios for growth in response to the Fed's actions in 2022 and 2023. The primary difference between the two scenarios is how the Fed reacts to the inflation we experience.

Scenario 1: Our base case has the Fed showing its patience by looking through a rise in inflation in the first half of 2022 and waiting for the labor market to heal before a liftoff in rates. The Fed is expected to accelerate the pace of tapering in early 2022 so that it can begin the process of raising rates by midyear.

Scenario 2: The FOMC gets more nervous about inflation. It picks up the pace of rate hikes in 2023 to prevent inflation from becoming entrenched. Rate hikes, combined with an unwanted surge in inventories, trigger a recession in 2024.

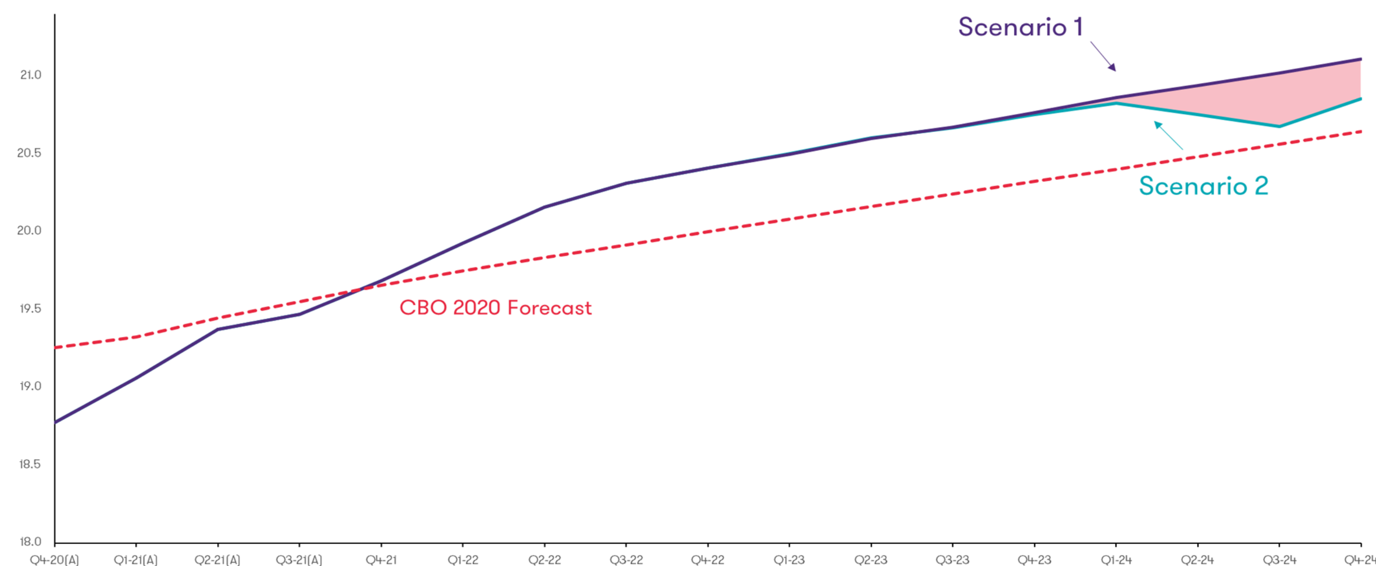
It is not the worst of what could happen. Developing economies would likely be forced to counter with rate hikes to defend their currencies. In response, the cost of servicing high debt loads would mount, which ups the risk of a debt default and a larger meltdown in financial markets. Those losses could wash up on our shores and compound a downturn triggered by a Fed misstep.

The forecast includes the bipartisan infrastructure bill, which doesn't fully hit the economy until the middle part of the decade. The government is not very efficient at getting funds allocated out the door; large-scale infrastructure projects take a long time to ramp up. They tend to boost productivity growth, which makes them less of a threat to overall inflation than other forms of spending like direct transfers to households.

We did not include the administration's spending package because it is still up for debate. How it is paid for matters for inflation. Transfer payments tend to be more inflationary than infrastructure spending if not paid for via taxes or cuts elsewhere.

Chart 1

Can the Fed Engineer a Soft Landing?
GDP, 2012 $, Trillions



Source: Bureau of Economic Analysis, Grant Thornton LLP

What's Driving Inflation?

There is much debate about what is triggering the current inflation:

A. A demand surge juiced by fiscal and monetary stimulus;

B. Global supply chain disruptions, which were exacerbated by the Delta variant of COVID;

C. Labor shortages, which emerged as firms pushed to ramp up faster than workers could or would return, given actual and perceived threats of contagion; or

D. All of the above

The correct answer is D: All of the above.

The impact the pandemic had on prices in spring 2020 - many prices plummeted - boosted year-on-year comparisons in spring 2021. Those "base effects," were supposed to dissipate as we moved into the summer but did not. Chairman Powell is betting they will work in reverse - inflation measures will abate - as we move into spring 2022.

A Demand Surge

The most recent round of stimulus far exceeded most economists' estimates of what was needed to fill the hole created by the pandemic. Add ultra-low rates and the Fed's reluctance to taper asset purchases, which were needed to stabilize financial markets and avert a financial crisis at the onset of the pandemic, and it is little surprise demand has surged.

Stimulus checks and low mortgage rates were leveraged to buy goods as people scrambled to make being homebound more tolerable. They repaired and remodeled, made space for offices and gyms. They upgraded their vehicles, bought new and vacation homes, RVs and boats. (Many are now on Craigslist.)

Demand for services was more fragile and susceptible to outbreaks but none-the-less significant. The Delta outbreak this summer provided insights into how rapidly consumers could pivot back into goods from spending on services when the threat of contagion picked up.

Demand is likely to remain elevated despite a sharp drain in savings and the loss of unemployment insurance for millions in September. Employment and wage gains picked up in October as the Delta wave abated, while employment over the summer was revised up sharply. The revisions to August and September added up to one full month of new hires. The private sector is picking up the baton from the public sector and gaining momentum as we move into the winter.

The saving rate is expected to dip well below its prepandemic levels in the months to come. The equity in homes and stocks skyrocketed, which will add to the gains in spending associated with stronger employment. It should take well into 2022 for demand to normalize.

That is assuming we have turned the corner on major outbreaks in the U.S., which is becoming more probable. Treatments for COVID have improved dramatically and are expected to limit hospitalizations, which is key to keeping health care systems from being overwhelmed. The availability of vaccines for children 5-11 years of age could be a game changer, especially for working parents.

The larger hurdle is the lag in the distribution of vaccines to developing economies. That increases the risk of more problematic variants and disruptions to supply chains and growth abroad.

Supply Chain Disruptions

Producers were caught off guard by the surge in demand following the shock of initial lockdowns. Factories were easier to idle when the threat of actual infections flared. Supply chain bottlenecks formed as plants in different countries reopened at different times. Empty containers to ship goods were standard at distant ports as transportation systems were stressed beyond capacity.

The crisis revealed deep inefficiencies and problems with our ports and other transportation systems. Containers couldn't be unloaded fast enough for workers to get paid; they are not compensated for waiting.

Climate change collided with the Delta variant to exacerbate disruptions. Taiwan and its chokehold on the production of computer chips is a key example. A fifty-year drought forced rationing of water, which is critical to production, while outbreaks idled plants for the first time.

Supply chain disruptions are likely to get worse before they get better. The number of cargo ships waiting to unload at California ports continued to swell in October. Efforts to work the ports 24/7 could help alleviate those backlogs but not cure the chronic shortages of truckers needed to distribute those goods.

The disruptions to production, mostly of refining capacity, have abated but left fuel costs rising as we enter the holiday season. Production picked up recently but factories are still filling backlogs, not new orders.

Work done by Oxford Economics suggests that inventory-to-sales ratios were still 70% below pre-pandemic levels at the start of the fourth quarter. Powell himself admitted it will take well into 2022 to work through the bottlenecks we face, at least six months later than hoped; those lags could prove even longer, given the unpredictable nature of the pandemic.

Inventories are so tight that producers are double ordering. We have not seen hoarding in decades; it could trigger a bullwhip effect, with producers eventually saddled with unwanted inventories. That is not likely until 2023. We could see a more traditional inventory cycle with price cuts and a recession.

Labor Shortages

Research done by the online hiring site Indeed shows that job postings were up nearly 50% at the end of October compared to February 2020. That translates to a record 11.1 million job openings by the end of October.

Those figures suggest that the demand for workers far exceeds the number of applicants; 7.4 million were actively looking for employment in October. I have never seen anything like it.

Labor supply is constrained. The number of workers who were out sick or not looking for work due to illness remained well above prepandemic levels in October. Long-haul COVID could be affecting more than a million.

Retirements soared during the crisis: 1.5 million more people retired than the precrisis trend. Some of those reflect a fear of working in frontline jobs; they could come back when contagion risks abate, civility returns and their savings run low. Another portion do not have to return because of the extraordinary rise in asset values.

Immigration, which was the largest single contributor to labor force growth in the 2010's, came to a virtual standstill as borders closed. Borders reopened to vaccinated foreigners on November 8, but it will take time to get foreign workers back. Immigration reform is necessary to attract and keep the workers we so desperately need.

Dropouts from grade schools to universities surged when education shifted online. Some just delayed graduation, which limited the pool of workers entering the labor force. Others will need to make up for education lost.

The ranks of the long-term unemployed remain elevated. Many were the last to get jobs in the previous expansion and the first to be cut when the pandemic hit. They have to find new employers, likely in a different location than they were prior to the pandemic. That takes more time than returning to a previous employer. Surging prices at the gas pump, a lack of mass transit to where the jobs and high rents are adding insult to injury; they are wiping out the surge in wages for low-wage workers, costing them more to search for jobs and preventing them from taking jobs that require long commutes.

Chairman Powell is optimistic that we can avoid a wage-price spiral, like we saw in the 1970s. Productivity growth has improved with the rapid adoption of technology prompted by the pandemic. Those gains justify a much needed boost in wages, especially for low-wage workers.

The problem is that productivity gains are not evenly distributed across companies. Large, tech-savvy retailers, which are driving wage gains for the lowest paid worker, are benefitting the most from the push to digitize and automate. They have the scale to exert more control on their supply chains, which gives them an edge in getting goods on their shelves.

The pandemic accelerated the concentration of employment in the largest retailers and is challenging small and midsize business models. That shift is important, as those same firms are less likely to be unionized, a key feature of the 1970s.

Implications for Inflation & The Fed

Charts 2 and 3 compare the trajectories of inflation and rate hikes under both scenarios. The biggest difference is the reaction of the Fed.

Scenario 1: Inflation is not likely to crest until the higher base effects we saw in 2021 start to make the math on inflation harder in spring and summer. Even then, service sector prices are likely to be surging as more of the pent-up demand for services is unleashed. Hotel rooms, rental cars and airfares could easily move up again, especially in light of diminished capacity.

A more worrisome concern is the move up in shelter and medical costs, which could place a floor on how low inflation goes in late 2022 and 2023. Shelter costs alone, which include rents and owners' equivalent rent estimates by households, have already begun to accelerate. It usually takes a year or more for the surge in home values to show up on measured rents; we crossed that threshold over the summer.

Medical costs are expected to rise in response to backlogs on routine exams and the return of elective surgeries. Those costs and the surge in rents could add more than one half of one percent to overall inflation measures in 2022.

Wages still have some room to run, despite our skepticism that could see the unionization and wage-price spirals we saw in the 1970s. Labor markets are expected to recoup what was lost to the crisis in the first half of 2022 and more fully recover by mid-year.

This is where it gets really tricky for the Federal Reserve. In Scenario 1, the Fed accelerates its tapering of asset purchases in early 2022 to allow more room for a liftoff in rates in the second half of the year.

The Fed starts liftoff over the summer of 2022, after labor markets have fully healed. We have three rate hikes in 2022 and another three in 2023. That would bring the fed funds rate to 1.625%.

Scenario 2: Inflation remains elevated a bit longer, while wage gains continue to rise at a surprising clip. The Fed moves forward with an acceleration of its plans to taper. The strength of the October employment report represented a major step in that direction. Liftoff begins a bit sooner, by June 2022.

The Fed then starts to panic that inflation expectations, which have a debatable effect on overall inflation, are becoming unanchored. Energy and food prices, which the Fed has less power to contain, play an outsized role in determining inflation expectations.

It is important to remember that central bankers are hardwired to worry more about inflation than the labor market. Chairman Powell is an outlier among his peers; he has more humility about the Fed's forecasting prowess and is not as skittish about inflation. He is willing to allow the labor market to fully heal before raising rates.

Chart 2

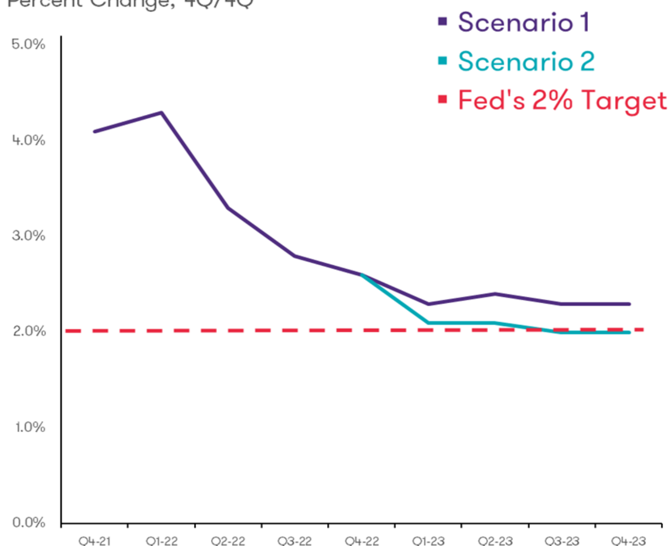
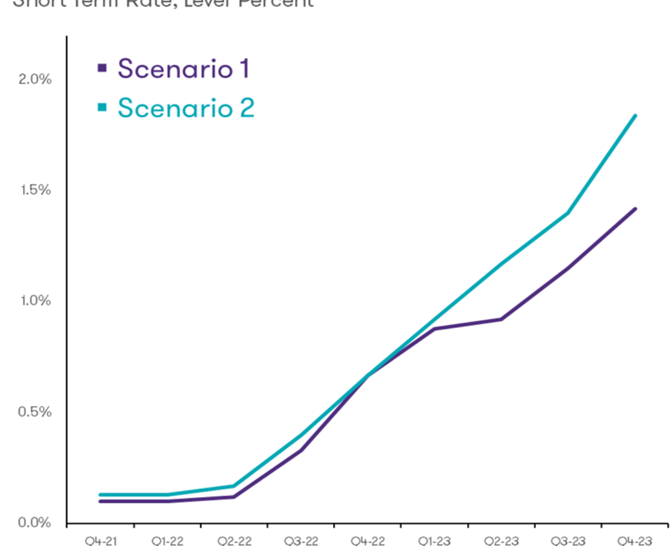


Chart 3



The key is what happens next. The Fed starts to chase down inflation forcefully. This gives us three rate hikes in 2022 and another five in 2023. That takes the fed funds rate back up to 2.125%, a bit below the peak we saw in the last cycle, which represented an overshoot. The rationale will be that both growth and inflation are much hotter this time around. Indeed, the peak in rate hikes could be even higher than it was in 2018, given much stronger growth and inflation the Fed is likely to encounter.

The yield curve inverts, demand slows and inventories go from being tight to bloated. The double ordering done to hedge against shortages earlier in the cycle comes home to roost. The economy slips into recession, with a lag, in 2024. Inflation slips back below the Fed's 2% threshold.

There is risk of a larger financial meltdown, especially as developing economies struggle to deal with a more rapid tapering of the Fed's asset purchase program and faster rate hikes. China has been a big buyer of our debt for a long time; it is no longer playing that role as it focuses on its own problems.

Why do we care? Financial markets are the oil of our economy; if they seize, the engine of the entire economy comes to a halt, not just Wall Street. Those who can afford it least are hit the hardest and any recession that results could be deeper and harder to recover from than we have seen in the wake of the pandemic.

Bottom Line

This Fed is still staffed with people who spent their careers preempting a nonexistent inflation; there is no precedent for how they will react to a more sustained surge in inflation. Chairman Powell is an outlier among his peers on this front.

The risk is that they panic and chase down inflation much like the stalker in Blondie's iconic hit. "One day, maybe next week. I'm gonna meet ya…I will drive past your house…I'll see who's around…I'll get ya."

That will end our relationship with inflation but at a hefty price. It could tip the economy into a recession, or worse, if those hikes reverberate across developing economies. I prefer more civil breakups; I have had some experience.

Economic forecast — November 2021

	2021	2022	2023	2021:2(A)	2021:3(A)	2021:4	2022:1	2022:2	2022:3	2022:4	2023:1	2023:2
National Outlook												
Chain-Weight GDP[1]	5.5	4.2	2.1	6.7	2.0	4.5	5.0	4.7	3.0	2.0	1.7	1.9
Personal Consumption	8.0	3.3	1.9	12.0	1.6	4.6	3.3	2.0	1.7	1.8	1.8	1.9
Business Fixed Investment	7.6	6.5	3.5	9.2	1.8	6.1	8.8	7.6	5.6	3.6	2.9	2.8
Residential Investment	8.6	-5.1	-7.7	-11.7	-7.7	-6.9	-4.2	0.6	-3.1	-10.9	-12.8	-8.2
Inventory Investment (bil $ '12)	-92	94	144	-168	-78	-34	17	90	128	140	152	158
Net Exports (bil $ '12)	-1265	-1290	-1243	-1236	-1303	-1301	-1306	-1293	-1289	-1274	-1258	-1241
Exports	3.7	5.2	6.9	7.6	-2.5	2.3	5.7	9.4	7.8	7.8	7.1	6.7
Imports	13.1	4.1	3.2	7.1	6.0	1.1	4.2	4.5	4.5	3.4	2.9	2.6
Government Expenditures	0.6	2.0	1.3	-2.0	0.8	-0.1	4.4	3.0	2.1	1.3	0.9	1.0
Federal	0.9	0.2	-0.2	-5.3	-4.7	-0.8	5.5	-0.1	0.3	-1.2	-0.2	0.3
State and Local	0.4	3.1	2.2	0.2	4.4	0.4	3.8	5.0	3.2	2.9	1.6	1.5
Final Sales	5.4	3.2	1.9	8.1	-0.1	3.6	4.0	3.3	2.3	1.8	1.5	1.8
Inflation												
GDP Deflator	4.0	4.0	2.4	6.0	5.6	5.2	4.8	1.9	2.5	1.9	3.1	1.8
CPI	4.5	4.5	2.2	8.5	6.6	5.5	5.0	2.7	2.1	1.7	2.8	1.7
Core CPI	3.4	3.6	2.6	8.2	5.3	3.0	3.7	2.1	2.8	2.4	2.8	2.4
Special Indicators												
Corporate Profits[2]	6.9	5.5	0.2	45.1	12.8	6.9	7.3	-1.3	1.3	5.5	0.0	-1.7
Disposable Personal Income	1.7	-3.4	2.5	-30.2	-5.6	-6.1	-1.3	3.7	3.2	1.8	2.3	2.7
Housing Starts (mil.)	1.58	1.43	1.18	1.59	1.57	1.55	1.54	1.51	1.41	1.28	1.21	1.18
Civilian Unemployment Rate	5.4	3.7	4.0	5.9	5.1	4.3	4.0	3.6	3.5	3.6	3.7	3.9
Total Nonfarm Payrolls (thous.)[3]	5963	917	66	1847	1883	1405	1021	1050	904	694	181	278
Vehicle Sales												
Automobile Sales (mil.)	3.4	3.9	4.0	3.9	3.1	2.8	3.5	3.8	4.1	4.1	4.2	4.0
Domestic	2.2	2.5	2.5	2.6	2.0	1.8	2.2	2.4	2.6	2.6	2.6	2.5
Imports	1.2	1.4	1.5	1.3	1.1	1.0	1.3	1.4	1.5	1.5	1.6	1.5
Lt. Trucks (mil.)	11.8	12.2	12.8	13.0	10.3	10.8	11.1	12.1	12.6	13.0	13.0	12.8
Domestic	9.1	9.4	9.9	9.9	7.8	8.4	8.5	9.3	9.7	10.0	10.0	9.8
Imports	2.7	2.8	2.9	3.1	2.5	2.4	2.6	2.8	2.9	3.0	3.0	3.0
Combined Auto/Lt.Truck	15.2	16.1	16.8	16.9	13.3	13.6	14.6	15.9	16.7	17.1	17.2	16.8
Heavy Truck Sales	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil.)	15.7	16.6	17.3	17.4	13.8	14.0	15.0	16.4	17.2	17.6	17.7	17.3
Interest Rate/Yields												
Federal Funds	0.1	0.3	1.1	0.1	0.1	0.1	0.1	0.1	0.3	0.7	0.9	0.9
10-Year Treasury Note	1.4	1.9	2.6	1.6	1.3	1.4	1.5	1.7	2.1	2.4	2.5	2.6
Corporate Bond BAA	3.5	3.9	4.7	3.6	3.3	3.4	3.4	3.7	4.1	4.5	4.5	4.7
Exchange Rates												
Dollar/Euro	1.19	1.18	1.21	1.21	1.18	1.15	1.16	1.17	1.18	1.20	1.20	1.21
Yen/Dollar	109.4	111.4	109.9	109.5	110.1	111.9	111.7	111.5	111.3	110.9	110.6	110.2

1. in 2020, GDP was $18.4 trillion in chain-weighted 2012 dollars.
2. Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.
3. Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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