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How to Cool a Hot Economy:

No "Good Recessions"

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"[N]early 100% of people are affected by high inflation; it punches a hole in the bank accounts of nearly everyone, those with and without jobs, those living on fixed incomes, underemployed, everyone."

Famed political analyst Charlie Cook argued that at the 38th Annual Policy Conference of the National Association for Business Economics (NABE) in Washington, D.C., March 20-22.

A recent poll by the American Psychological Association agrees with him. A stunning 87% of adults reported that escalating prices of everyday items including groceries, gasoline and energy bills were causing them stress.

The Federal Reserve has taken note. "My colleagues and I are acutely aware that high inflation imposes significant hardship, especially on those least able to meet the higher costs of essentials like food, housing, and transportation," Chairman Jay Powell underscored in his prepared remarks.

Powell made it clear that inflation is now the primary focus of the Fed instead of employment. He defended aggressive rate hikes. When asked what would stop him from a 0.5% hike in May, he dead panned, "Nothing."

He tried to reassure that the Federal Reserve could achieve a "soft" landing, but even then, he qualified his answer. He argued the Fed has a history of achieving "soft-ish" landings when dealing with inflation.

The Economy Stalls

Real GDP is expected to nearly flatline in the first quarter of 2022, but domestic demand should hold up better. Consumer spending slows but does not collapse in the face of Omicron. Home buying and building moves higher, while business investment posts solid gains. The largest losses are expected to occur in inventories and trade. Exports are forecast to fall with lockdowns and the war abroad. Government spending likely disappointed, as schools temporarily moved back online during the Omicron wave.

Prospects for the second quarter are better. Consumer spending is expected to slow but not collapse with the pivot from goods into services. Housing is expected to cool and business investment is expected to slow; investment in the shale industry is an exception. The trade deficit is expected to hold close to the record level hit in the first quarter. Government spending should pick up now that schools are ramping up and Congress has finally passed a fiscal 2022 budget.

The economy is forecast to hit a wall in the second half of the year in response to rate hikes by the Federal Reserve and higher prices at the gas pump. Consumer spending could actually contract, while home buying and building are expected to drop. Investment stalls; inventories remain tight. The trade deficit narrows slightly. Government spending is buoyed by state and local gains.

Fed Hits Brakes. The Fed is expected to accelerate rate hikes and begin reducing its balance sheet in May. Rate hikes are expected to persist through much of 2023.

The two are not the same. The first occurs when rate hikes slow growth but do not stop the progress being made on employment. The second is more akin to a "growth recession" or a slowdown in growth that is too weak to keep the unemployment rate from rising.

The Fed has two mandates: to foster full employment and promote price stability. It has not had to choose between the two for decades; now it must. A more entrenched inflation erodes living standards and could trigger a worse recession than a Fed-induced slowdown.

Inflation will get worse before it gets better. The Consumer Price Index could hit 8.5% in March, its hottest pace since 1981. Lockdowns in China will exacerbate supply shocks along with those related to the war in Ukraine. The push to regionalize supply chains and cushion against future shocks with just-in-case instead of just-in-time inventories will add to price pressures.

This is at the same time that the pandemic and war are accelerating the move away from globalization. That means we could be in for a more inflation prone, post-pandemic world; the Fed will have to be more vigilant about inflation going forward than it has in recent decades. Get used to a more active Fed, much like we saw in the late 1980s and early 1990s.

This edition of ***Economic Currents*** takes a closer look at how the Federal Reserve's views have shifted, how members plan to combat inflation and what those shifts are likely to mean for the labor market. Be careful what you wish for. There are no "good recessions." They are indiscriminate in the pain they cause. Workers only become plentiful when firms no longer have jobs to fill.

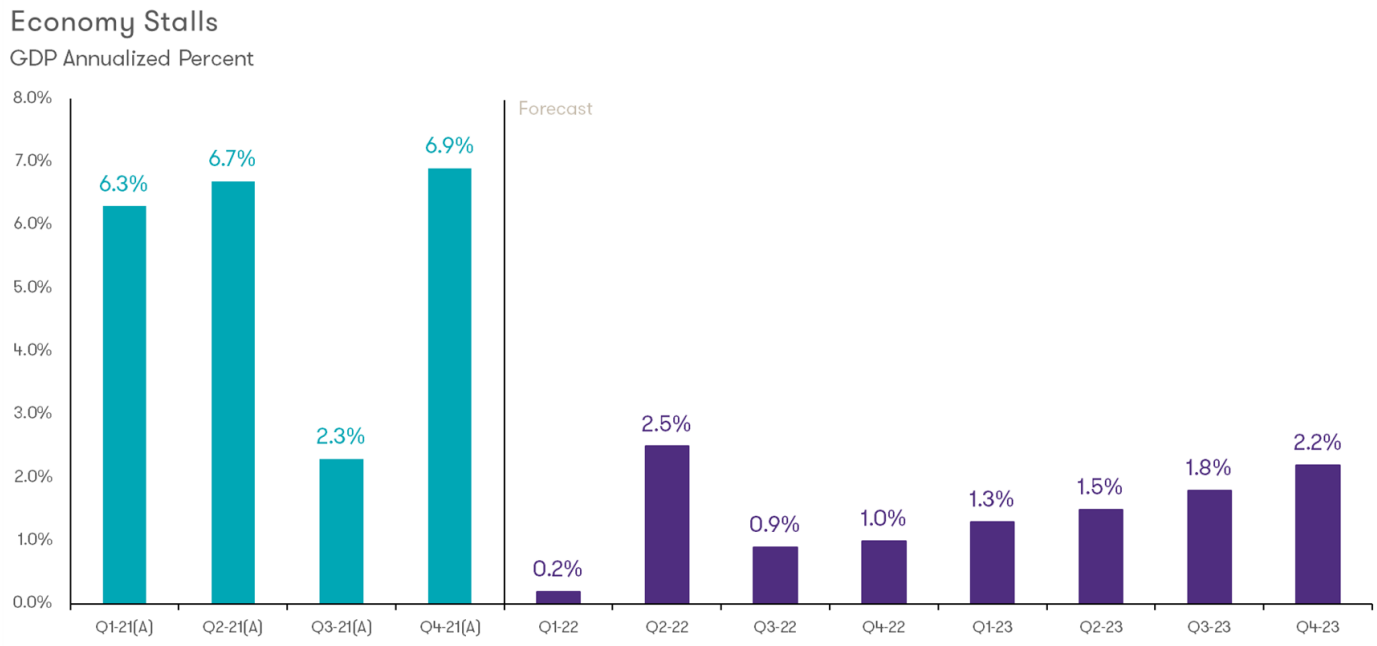
Something Doesn't Add Up

The participants at the March Federal Open Market Committee (FOMC) dramatically changed their outlook over the last three months:

- Growth was marked down;
- Inflation was marked up;
- Rate hikes more than doubled in 2022; but
- The unemployment rate barely moved; it hits a record low in 2022 and stays there in 2023.

Either the economy is remarkably resilient, which would argue for more aggressive rate hikes, or growth is likely to slow more rapidly than the Fed is willing to admit. The result is an increase instead of a decrease in unemployment by year-end.

Chart 1



Source: Bureau of Economic Analysis, Grant Thornton LLP

Our analysis suggests that the headwinds triggered by the war in Ukraine and rate hikes will be greater than those laid out by the Fed. Any resolution to the war can't restore infrastructure destroyed, while sanctions on Russia are likely to remain in place.

The economy could come to a virtual standstill in the second half of 2022 and early 2023. Those losses would trigger an increase instead of a decrease in unemployment. The economy effectively slides into a recession with growth so weak. (See Chart 1.)

Much of Europe is already slowing in response to the surge in energy prices and disruptions to supply chains. Vehicle production at plants in Germany was idled when a key supplier in Ukraine was shuttered.

If we are wrong about the slowdown, then the Fed will have to act more aggressively. The latter is why many Wall Street banks have front-run the Fed on rate hikes. Some have the Fed raising rates 1.0% by June.

We haven't seen a tightening like this since 1994, when the Fed raised rates from 3% to 4.25% in four months' time. Rates doubled to 6% by early 1995. The economy stalled out and unemployment edged higher. The Fed was forced to make a u-turn and cut rates in the second half of 1995. That was with fewer headwinds than we are facing today. Brace yourself.

Interest rate sensitive sectors will be hit hardest. These include real estate, big-ticket spending on vehicles, appliances, furniture and home remodeling. Those are sectors that have experienced the highest inflation.

How Will the Fed Tighten Credit?

The FOMC prefers to use rate hikes over reductions in its bloated balance sheet to tighten credit conditions. They are easier to communicate than changes in the balance sheet and their effects are well understood.

> "We could be in for a more inflation prone, post-pandemic world."

The Fed is expected to raise rates by another 0.75% by June and 1.0% in the second half of the year. That puts the fed funds rate at 2.25% by year-end, which is at or above what many on the Fed consider neutral.

As long as inflation is decelerating on both an annual and a month-to-month basis by year-end, the Fed will slow the pace of rate hikes in 2023. We expect another three next year. That would put the terminal rate for the fed funds rate at 3%. Some pundits, such as former Treasury Secretary Larry Summers, have argued the Fed needs to raise rates to 4%-5% to bring down inflation.

The challenge for the Fed is that rate hikes are nonlinear and operate with a lag. FOMC members will not know that they have gone too far until well after they have arrived. Further complicating the calculus on rate hikes is the Fed's desire to reduce its balance sheet, which is an economic quagmire.

The Fed decided on a road map for how it intends to accomplish that at its March meeting. Those details will be released April 6. The Fed could allow $50 billion in U.S. Treasury bonds and $30 billion in mortgage-backed securities (MBS) ($80 billion total) to mature and roll off the balance sheet each month. It is expected to begin in May, which will reduce the balance sheet by about $600 billion by year-end. The goal is to cut $3 trillion from the balance sheet over three years.

How will those actions amplify rate hikes? Estimates are all over the place, from zero to well over one percent. (E.g., we could get well within Larry Summers's range of 4%-5% with reductions in the balance sheet.)

The challenge is the law of unintended consequences. The Fed's balance sheet operations are complex and full of economic landmines. No one knows exactly what the spillover effects of balance sheet reductions will mean for global financial markets.

The "taper tantrum" in 2013 tipped off a series of rate hikes in emerging markets, bringing some to the brink of default. The risk is even higher today given the mountain of debt many emerging markets have taken on to deal with the pandemic.

The goal is for the Fed to tighten credit market conditions, not trigger a seizure in credit markets. The latter is much harder to recover from than a Fed-induced slowdown.

That is because credit markets can't respond to a subsequent lowering of interest rates or easing of credit conditions until they rid themselves of the overhang of bad debt that triggered them. Think of how hard it was to qualify for a mortgage when your current mortgage was still underwater in the wake of the subprime crisis.

Emerging markets in Asia are better positioned to weather the storm than emerging markets in Africa, which have large debts to China. Parts of Latin America could be in jeopardy. The war has increased the stress on emerging economies in Eastern Europe. Russia, Ukraine and Turkey are already suffering (gross understatement).

Uncertainty about the fallout of balance sheet reductions is expected to prompt the Fed to err on the side of caution. It may stop short of its $3 trillion goal and delay the sale of MBS.

The Fallout for Labor Markets

Powell would like to slow the pace of hiring so that it more closely resembles what we saw at the end of the last expansion. In late 2019 and early 2020, the ratio of job openings per job seeker was one-to-one.

Back then, wages were accelerating faster than, but not adding to, inflation. Participation in the labor market was rising. People who had been cast aside or ignored by employers were given a second chance. Even the ranks of those on disability were falling.

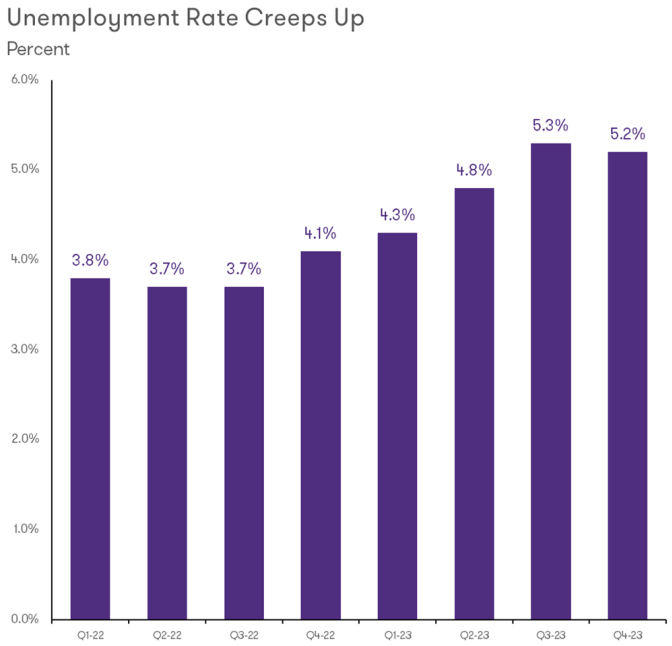
The road from here to there is littered with potholes. In February, we had a stunning 1.8 job openings per job seeker. The good news is that participation in the labor force is improving.

If we can get back to the participation rate we saw in February 2020, we could bring down that ratio to 1.3 job openings per worker. That leaves us with nearly three million more job openings than workers.

About half of the loss in participation since the onset of the pandemic was due to a surge in retirements. It is unlikely that the majority of those workers will return. That means that the Fed must more forcefully reduce the demand for workers.

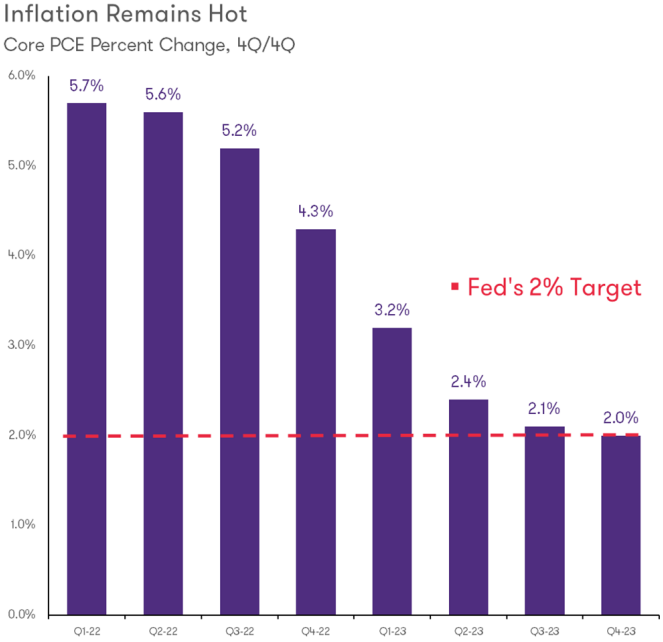
Job openings need to fall by at least 25% to get demand more in line with the supply of workers. We have never seen such a large drop without a recession. That means an increase in the unemployment rate.

Chart 2



Source: Grant Thornton LLP

Chart 3



Source: Grant Thornton LLP

Chart 2 shows the forecast for the unemployment rate; it rises above 4% by year-end 2022 and exceeds 5% by year-end 2023. That would cool inflation to the Fed's 2% target by the end of 2023. (See Chart 3.) The silver lining is that the Fed could reverse course and cut rates in late 2023/early 2024.

The last sentence is important. Any recession that erupts could be short-lived. If the only hurdle to recovery is the Fed, then credit markets will quickly ease and labor markets will rebound.

We are facing structural shifts, not the least is the move away from globalization. That will likely make the post-pandemic world more prone to inflation and force the Fed to more actively manage business cycles. The era of long expansions could come to an end.

The backlash to globalization is showing up in the labor market as a sharp drop in immigration. We don't have enough workers to offset the ranks of baby boomers entering retirement. This is one of many reasons that Powell endorsed increases in immigration. They would allow a boost in growth, reduce the risk of acute labor shortages and reopen the door to longer expansions.

Bottom Line

Chairman Powell has **agreed** to do "whatever it takes to restore price stability." That means more aggressive rate hikes than we have seen in decades. What was the strongest and fastest recovery on record may soon be among the shortest. A growth recession is likely; unemployment will rise.

Any kind of recession is painful. Those waiting for a recession to hire workers may find themselves without the jobs they had hoped to fill.

Worse yet, recessions could become more frequent if we can't limit some of the imbalances we face on the other side of the crisis. We can't turn back the hands of time but we can curb the effects of aging. By opening our arms to refugees, we could foster more robust and sustained recoveries. Kindness heals.

Economic forecast — April 2022

	2021	2022	2023	2021:4(A)	2022:1	2022:2	2022:3	2022:4	2023:1	2023:2	2023:3	2023:4
National Outlook												
Chain-Weight GDP[1]	5.7	2.7	1.4	6.9	0.2	2.5	0.9	1.0	1.3	1.5	1.8	2.2
Personal Consumption	7.9	2.5	1.2	2.5	2.4	1.7	-0.4	1.2	1.0	1.7	2.0	2.5
Business Fixed Investment	7.4	5.2	0.9	2.9	9.5	6.9	1.6	0.0	0.5	0.1	0.3	1.4
Residential Investment	9.2	-2.8	-8.9	2.1	4.0	-0.7	-9.4	-13.7	-11.1	-7.2	-6.6	-1.2
Inventory Investment (bil $ '12)	-33	107	88	193	107	111	119	92	92	86	88	86
Net Exports (bil $ '12)	-1284	-1381	-1223	-1350	-1425	-1425	-1371	-1305	-1256	-1227	-1206	-1203
Exports	4.5	5.6	2.6	22.4	-1.8	7.1	4.9	4.1	5.1	4.2	3.9	4.4
Imports	14.0	6.6	-1.2	17.9	8.9	4.4	-2.5	-4.2	-1.9	-0.4	0.4	2.6
Government Expenditures	0.5	0.1	1.7	-2.6	-0.3	1.6	2.4	1.7	1.4	1.5	1.7	1.6
Federal	0.6	-1.4	0.9	-4.5	0.4	0.8	2.0	-0.2	0.7	1.1	1.2	1.2
State and Local	0.4	1.1	2.1	-1.4	-0.6	2.0	2.6	2.9	1.8	1.7	2.1	1.8
Final Sales	5.3	1.9	1.5	1.5	1.5	2.4	0.8	1.6	1.3	1.6	1.8	2.2
Inflation												
GDP Deflator	4.2	6.0	2.7	7.2	7.7	6.3	2.4	1.8	3.0	3.0	1.5	2.1
CPI	4.7	6.4	2.1	7.8	9.5	6.3	0.7	0.6	3.1	2.5	1.4	1.8
Core CPI	3.6	5.6	2.7	5.6	7.4	6.0	3.0	1.9	3.0	2.8	1.5	1.9
Special Indicators												
Corporate Profits[2]	17.7	-4.4	4.3	17.7	10.4	0.3	-4.9	-4.4	-2.1	-1.0	2.4	4.3
Disposable Personal Income	2.2	-4.6	2.8	-5.6	-5.3	-0.2	3.2	1.8	3.0	3.1	3.7	4.4
Housing Starts (mil.)	1.60	1.56	1.30	1.65	1.71	1.65	1.50	1.37	1.36	1.30	1.25	1.28
Civilian Unemployment Rate	5.4	3.8	4.9	4.2	3.8	3.7	3.7	4.1	4.3	4.8	5.3	5.2
Total Nonfarm Payrolls (thous.)[3]	5390	1087	-304	1952	2373	1281	485	210	-333	-495	-610	221
Vehicle Sales												
Automobile Sales (mil.)	3.4	3.3	3.4	2.7	3.0	3.4	3.3	3.4	3.4	3.5	3.5	3.3
Domestic	2.2	2.2	2.3	1.8	2.2	2.3	2.1	2.2	2.2	2.3	2.3	2.2
Imports	1.1	1.1	1.2	0.9	0.8	1.1	1.2	1.2	1.2	1.2	1.2	1.1
Lt. Trucks (mil.)	11.7	11.3	11.0	10.3	11.5	11.7	11.1	10.7	10.5	10.9	11.1	11.5
Domestic	9.0	8.9	8.6	8.2	9.1	9.3	8.7	8.4	8.2	8.5	8.7	9.0
Imports	2.6	2.4	2.4	2.2	2.4	2.4	2.4	2.3	2.3	2.4	2.4	2.5
Combined Auto/Lt.Truck	15.1	14.5	14.4	13.0	14.5	15.1	14.4	14.1	13.9	14.4	14.6	14.8
Heavy Truck Sales	0.5	0.5	0.4	0.4	0.5	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Total Vehicles (mil.)	15.5	15.0	14.8	13.5	15.0	15.6	14.8	14.5	14.3	14.8	15.0	15.2
Interest Rate/Yields												
Federal Funds	0.1	1.0	2.7	0.1	0.1	0.7	1.3	1.8	2.4	2.7	2.9	2.8
10-Year Treasury Note	1.5	2.6	3.1	1.6	2.0	2.6	2.8	3.0	3.1	3.1	3.2	3.2
Corporate Bond BAA	3.5	4.7	5.3	3.4	4.1	4.8	4.9	5.1	5.1	5.3	5.4	5.2
Exchange Rates												
Dollar/Euro	1.18	1.12	1.17	1.14	1.12	1.10	1.12	1.13	1.14	1.16	1.18	1.20
Yen/Dollar	109.8	116.7	111.4	113.6	115.3	118.4	117.7	115.5	113.2	111.7	110.7	109.9

1. in 2021, GDP was $19.4 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.