Of Rates and Recessions (Third of a Series)

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This week we continue unpacking the rich content our three top economists provided for last week's exclusive webinar [link]. Here are some key takeaways.

Nominal GDP remains relatively high in the US, with greater growth reflected in higher corporate revenues and earnings. But real GDP is zero. 3Q is likely positive, thanks to a narrowing trade deficit, but still overall "lackluster." Jobs are higher with low unemployment, though no increase in output. Lower productivity translates to lower cost of living gains.

Still feels like 2019, especially in the job market with number of workers. Underemployment is down, but inflation and wages are up. Same number of workers, but 10-12 million more jobs! Low productivity comes with new employees who take longer to get up to speed. Inflation is handing inflation from goods (too many) to services. Also, not enough supply of workers.

For telling indicators look at nominal GDP and consumption: we're in disinflation's early stages. Look at unemployment claims, the ADP wage tracker and OIS spreads. Also "final sales to domestic private purchases" which isolates consumer spending and private investment.

Too many job openings, 10 million, versus 6 million unemployed workers. That gap pushes up wages. The Fed is also looking at profit margins. If they begin to shrink it means hikes are working. Consumers are not buying durable goods (e.g. outdoor appliances and grills). But hard to accomplish all this – decline in job openings and wages – without increasing unemployment.

Inflation is persistently higher. CPI is rent-weighted with a twelve months lag. Current labor market dynamics very different than old models. Any standard model would have predicted this inflation. Participation rate lower, so will take more for the Fed to influence it.

Inflation does lag. A recession analysis of OER and rent shows these are major inflation drivers (shelter is the largest component of CPI and PPI). Studying past recessions, 100% of the time when Fed had easy money, then hiked, they had to raise rates above predicted inflation levels.

The Fed target keeps getting pushed higher. Severe uncertainty is impacting markets. Calls to pause will increase. Early in the year, the expectation was 75 bps in total rate hikes for *all* of 2022. Today that's just a normal meeting hike! As the Fed keeps hiking the discount rate will go higher. "Immaculate disinflation" won't happen. November will be a 75 bps hike, December likely 75 bps as well. Hard to see meaningful disinflation in services. Current pace of 300-400k monthly jobs added dwarfs historic numbers; we're running out of extra workers.

Predicting unemployment is tricky. It's tough getting laid-off people back to work, so employers trying to retain workers. They don't want to "over-fire." In the past two recessions GDP fell sharply and unemployment was up. But in the prior two downturns real GDP was only down modestly. So maybe we end up at 5-5.5% unemployment. Business and consumer balance sheets are much better today. Expect economy to bottom in the middle of next year.