Economic **INSIGHT**

June 24, 2022

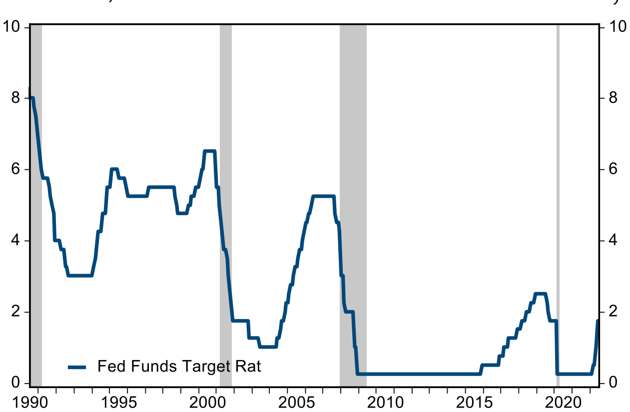
Supply-Side Price Pressures to Determine Depth and Duration of Downturn

At the latest June Federal Open Market Committee meeting, in a somewhat unexpected move, the Federal Reserve (Fed) opted to accelerate the size of rate hikes by increasing the upper bound of the federal funds target range 75 basis points (bps) to 1.75%, the largest increase since 1994. Of course, while the debate continues over whether or not this was the appropriate course of action, investors are focusing on the bigger picture in terms of economic activity and the sustainability of positive growth. What does the latest policy decision mean for the economy? Will the economy fall into recession? And if so, how deep and how long will the contraction be?

75 BPS IN JUNE

The most basic analysis of future market conditions begins with the determination of whether or not the U.S. economy will fall into recession. The answer is most assuredly yes, as recession at some point is inevitable in the market cycle. The devil, however, is in the details of when such weakness sets in, how intense it will be, and for how long. Going into 2022, the base-case assumption for activity was roughly 2% GDP, or simply a return to pre-pandemic growth amid a somewhat benign monetary policy pathway, rising above crisis-level support but remaining shy of restrictive. Now, with the Fed taking a decisively more aggressive approach to rates, slower growth is anticipated in the coming quarters, and there is a rising risk of recession due to the Committee's move to raise rates at larger intervals.

In March, the Fed increased the federal funds rate by 25 bps, followed by a larger increase of 50 bps in May. The Fed's latest decision to take an even more forceful approach to inflation has likely accelerated the timeline for more significant weakness. In fact, some economists and Federal Reserve analysts insist we may already be in or on the very brink of recession.



Source: Federal Reserve Board/Haver Analytic

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In the Federal Reserve's June FOMC statement, the Committee noted that overall economic activity appeared to have "*picked up*" after edging down in the first quarter. Of course, to the Fed's point, while growth may have improved from a 1.5% decline January to March on a relative basis, with consumers and businesses under mounting pressure from a lack of access to available materials and labor, as well as elevated prices, activity is expected to remain tepid at best in the second quarter. According to the latest Atlanta Fed GDPNow forecast, growth is likely to remain flat (0.0%) April to June, down from an earlier estimate near 2.5%. In other words, after a negative first quarter, according to some researchers at the Fed, the U.S. economy may be just one-tenth of a percentage point shy of signaling recessionary conditions.

RECESSION OR STAGFLATION?

By quickening the pace to remove accommodative monetary policy, the Fed has renewed – and upped – its commitment to reining in inflation, a focus that is expected to pose a significant cost to the U.S. economy and more specifically the average American. At the same time, a more violent approach to raising rates will likely result in a restrained impact in cooling supply-side pressures. After all, raising the cost of capital can drive down consumption and investment, easing demand-side pressures as is already evident with a softening pace of sales, but it does little to address supply-side constraints resulting in the aftermath of COVID-19 or as the result of international conflict. Thus, despite Federal Reserve Chairman Jerome Powell's declaration during the June FOMC press conference last week that the Fed is not trying to induce a recession, implementing such an accelerated policy pathway and raising rates at the fastest pace in almost three decades, will almost assuredly result in negative growth or an outright technical recession.

A recession is not the only possible negative outcome for the U.S. economy. In fact, a recession may be the relatively best-case scenario or the least bad. The worst-case scenario is stagflation. Thus, the answer to the question regarding the depth and duration of the eventual downturn greatly depends not only on negative growth, but also whether or not broader price pressures decline along with growth.

At this point, aware of its policy limitations with issues on the supply side, such as shortages of everything from food to energy, the Fed is simply trying to tackle inflation as much as it can by tamping down the demand side, which will hopefully allow supply to catch up. If balance is restored to the global marketplace and resolution reached overseas in short order, the period of negative growth is likely to be modest and relatively brief, particularly if the Fed were willing to reverse course and provide as much support to the economy as realistically possible.

Alternatively, if the Fed continues along an accelerated pathway to higher interest rates without improvement in international conditions, demand will expectedly slow along with the broader economy, but prices would remain elevated. This would compound the downside pressure on consumers and businesses. Remember, the Committee is

GLOSSARY

CPI: Consumer Price Index

FOMC: Federal Open Market Committee

GDP: Gross Domestic Product

PCE: Personal Consumption Expenditures

PPI: Producer Price Index

YoY: Year over Year

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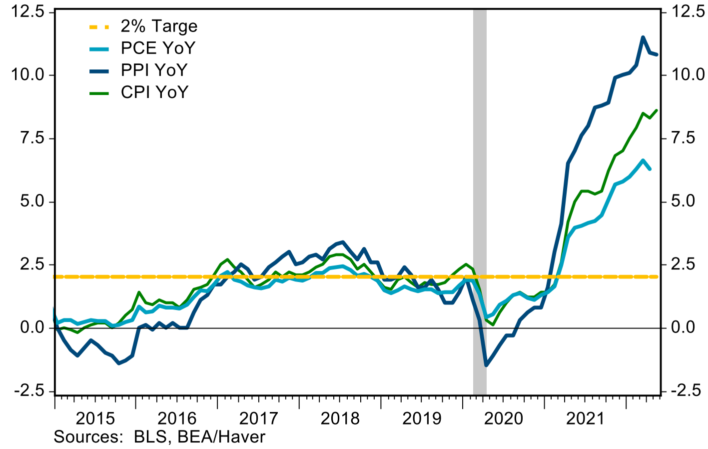
limited to its ability to influence the demand side. A solution to the supply side can only come through an easing of supply-chain pressures, which is out of the control of the Fed.



In this scenario, a significantly tighter monetary policy is likely to create a more persistent and intense level of weakness in the economy. The Fed would be forced to consistently raise rates in the name of tackling inflation, while consumers would continue to shoulder elevated costs as supply chains remain in disarray and conflict persists overseas. Households and businesses would also face higher borrowing and capital costs as well as the effects of a weaker economy. Economists call this double whammy stagflation.

WHAT'S IN A NAME?

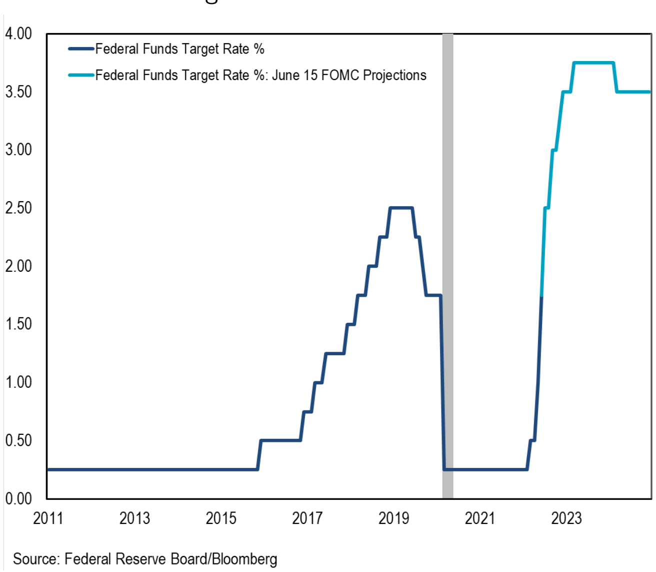
Stagflation, a term coined by British politician Iain Macleod in the 1960s, was by nature a contradiction to the general economic theory that an economy cannot have both high inflation *and* stagnant growth. However, a series of oil price spikes resulting in just that – elevated inflation and high employment – in the 1970s supported the notion that theory does not always represent reality.

Stagflation is incredibly uncommon, yet the consequences of it can be dire for economic growth. The last time the United States – and the world – fought stagflation, U.S. interest rates reached double-digits, the global economy tumbled, and a number of countries around the world were dragged into a lasting financial crisis.

While most agree the U.S. economy is not in a period of stagflation yet, rising prices, particularly in the energy market, and slowing growth are stoking the potential for that possibility.

WHAT'S A FED TO DO?

Standing between recession and stagflation is a Federal Reserve that more recently has taken a tough(er) stance against inflation. Some argue that if the Fed has the "*resolve*" to keep tightening monetary policy until price pressures abate, inflation – and the risk of stagflation – can be wrung from the system. But to what extent? An escalation of funding costs for six months, a year, maybe longer, could push the economy off track for years. As Powell conceded during his semi-annual policy testimony earlier this week, "*it's possible*" the Fed raises interest rates enough to cause a significant recession.



Of course, when the time comes, the Fed can quickly reverse course, presumably armed with a relatively larger arsenal to provide support to the economy. After all, the higher the Fed raises rates now, the more leeway it has to cut them in the future. However, if the duration of the tightening cycle preceding a reversal in policy is significant, a reduction in capital costs will most likely be of little consolation to consumers and businesses hammered for years by persistently elevated costs.

Is the economy destined for weakness? Is it no longer a question of *if* but *when*? Not necessarily. The bright spot in the discussion of lasting price pressures and the threat of recession or stagflation comes amidst the most recent signs of price pressures already abating, at least in some areas such as transportation and medical care costs. While the period of higher inflation is far from over, even small signs of cooling – or a second derivative decline on an annual basis – could allow topline prices to at least moderate through year-end and support expectations that the worst of the stress may be behind us.

While the 1970-1980s offer the best comparison from a stagflation standpoint and the subsequent impact from tighter policy, the U.S. consumer and average balance sheet is arguably on better financial footing. Partly due to the trillions in federal stimulus funding over the past two years, debt as a percent of disposable income is at the lowest level in more than four decades. Thus, the American household may be able to weather a relatively longer period of market disruption than previous generations. And should broader price relief come sooner than later, the fallout may be somewhat mitigated.

Of course, the above analysis assumes ceteris paribus, but rarely do factors in a multi-dimensional global marketplace remain unchanged. New unexpected shocks could emerge, undermining the recovery or any hopes of a shallow, less persistent downturn. For now, we remain optimistic that the U.S. economy will not be thrust into a severe downward spiral, but there is a countless list of unanticipated variables that could derail a more positive outcome.

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