November 2, 2022

Inflation, Inflation, Inflation… And Recession

Economic INSIGHT

This week, I had a wonderful opportunity to moderate a panel discussion titled, "*Inflation, Inflation, Inflation…and Recession*," at the Securities Industry and Financial Markets Association Annual Meeting in New York City. With inflation at a four-decade high, an economy that is treading water, and the Federal Reserve (Fed) assessing the size of its next rate hike, there was more than enough to discuss and some notable takeaways as well.

Pictured left to right: Dr. Lindsey Piegza, Managing Director, Chief Economist, Stifel; Jay Bryson, Managing Director, Chief Economist, Wells Fargo; Ethan Harris, Head of Global Economics Research, Bank of America

LEVEL OF PRICES: HOW HIGH IS HIGH?

One of the most basic questions many market participants are asking is, "has inflation peaked?" And if the answer is "no," the next question is typically "when will it peak?" As one panelist noted, establishing the timeline for a downward trend in inflation is probably more important than pinpointing the ceiling. Because then, and only then, can the Fed begin to feel assured that its policy initiatives are taming the inflation beast.

Right now, the Fed is seemingly confident inflation will establish a discernable downward trajectory in the near term, reaching 2.8% sometime next year. However, as one panelist noted, the market – and the Fed – have consistently underestimated the upward nature of prices. In fact, looking at historical forecast data on *Bloomberg*, the median consensus for inflation is often 50 - 100 basis points (bps) – or more – shy of the realized level of costs. The Fed's forecast is also regularly below the pace of price pressures that materialize in the marketplace by 100 – 200 bps, sometimes 300 bps. That differential, of course, could be at least partly by design. It's difficult, one panelist noted, for the Fed to just *"come out and say inflation is too high, so we're going to tighten into recession."* The Fed needs to temper its expectations – or the market's expectations for that matter – for rapidly rising prices.

Lindsey M. Piegza, Ph.D.
Chief Economist
piegzal@stifel.com

Lauren G. Henderson
Economic Analyst
hendersonla@stifel.com

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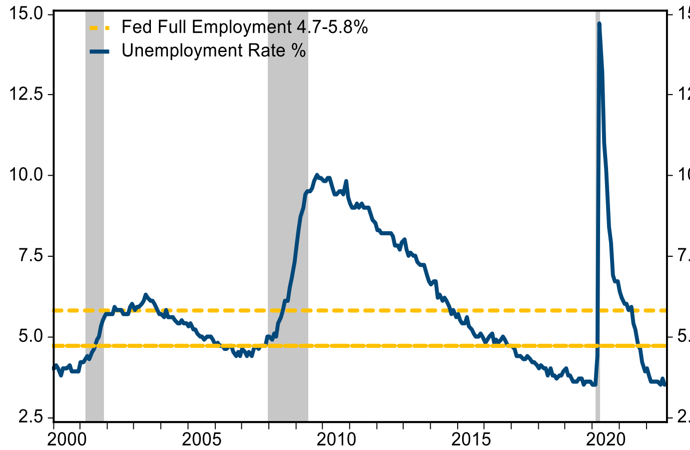
CAUSES OF INFLATION

It is widely accepted that several factors contributed to the extreme hyperinflation the U.S. economy is experiencing today, including supply-chain constraints and pent-up demand. The weight of those factors, however, is far from uniform. The panelists agreed that supply-side issues were the predominant force pushing up price pressures and dislocations up and down international supply lines will likely remain for a period of time. One panelist quantified the timeframe as 2 - 5 years, particularly with China's Zero-COVID policy still being fiercely enforced and international conflict exacerbating or prolonging the timeline for improvement. Depending on the industry, product, and location, it can often take two weeks to recover from a single day's shutdown, thus the recovery time for years of disruptions and capacity limitations will be much longer.



Source: Bureau of Labor Statistics/Haver Analytic

On the demand side, while arguably crisis-level policy was warranted at the onset of the global COVID-19 crisis, panelists agreed it was the trillions in stimulus that spurred an insatiable level of demand, resulting in a significant rise in wages and broader-based cost pressures that further accelerated earnings *expectations*. One panelist also noted that the structurally low level of labor force participation could potentially perpetuate wage pressures for years into the future. "*This isn't a tight labor market*," the panelist said, "*this may be the tightest labor market in history… I don't mean to be a pessimist, but we need to see a materially higher level of unemployment to reinstate a more normal level of inflation*."

From a shopper's perspective, the distinction between supply-side and demand-side inflation is understandably less of a concern; regardless of the cause, grocery store prices are up anywhere from 5% to 30%. However, from a policy standpoint and from a broader growth perspective, it does matter. While both types of inflation lead to higher prices, supply-side pressures also result in a reduction in output, increasing the potential for a downturn or outright recession as the Fed continues to raise rates, despite the tightness in the labor market.

GLOSSARY

YoY – Year over Year

CPI– Consumer Price Index

FOMC – Federal Open Market Committee

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

SIFMA – Securities Industry and Financial Markets Association

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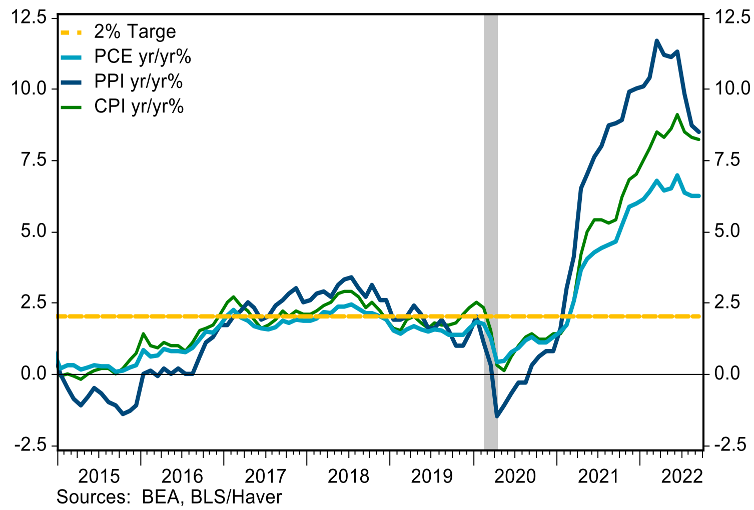
INTERNATIONAL PRICE PRESSURES

At the start of the recovery, inflation was higher in the U.S. than almost anywhere else in the world due to the unusual composition of inflation – meaning both demand *and* supply side distortions. This unfavorable distinction has dissipated, as inflation overseas now appears to be accelerating more quickly than in the U.S.

Panelists largely agreed the uptick in inflation pressures abroad was largely the result of the ongoing and compounding impact of global trade restrictions and supply chain distortions. One panelist described it as the "*worst they've seen over there in modern history*," suggesting some American businesses have been relatively more resilient or adaptable to current conditions. The rising cost of energy and ongoing limitations to parts and materials are also likely to maintain, if not compound, pressure on already rising costs here in the U.S. Those price pressures, however, may be more intense overseas.

FIGHTING INFLATION

Pivoting into the policy response to fight inflation, the Fed has been clear that restoring price stability is the Committee's key objective. However, against the earlier assessment of inflation being driven largely by supply-side variables – factors that are outside of the Fed's control – as well as demand-side pressures that includes a structurally inadequate labor supply, the panel was in agreement the Fed will have an increasingly difficult time reining in inflation with monetary policy metrics alone. As one panelist aptly noted, "*the Fed can't print more ships*."



Should the Fed maintain the resolve to reinstate price stability – which remains a sizable question mark for the panelists – they will likely need to raise rates materially above earlier expectations. Of course, even with markedly higher rates, the Fed may still be unsuccessful in returning inflation nearer its 2% target without a little "*hope*" of international dominos falling in place. In fact, with the Fed presuming a return to near 2% inflation by 2023, not to mention accompanied by still-positive growth and a 0.6% increase in unemployment, the panelists agreed with the moderator's assessment that Fed members are "*overly optimistic*" in their forecast for and ability to control inflation.

As was stated by the moderator, "*The Fed appears to have lost grips with reality. At no time in history has the unemployment rate risen that much without recession ensuing*."

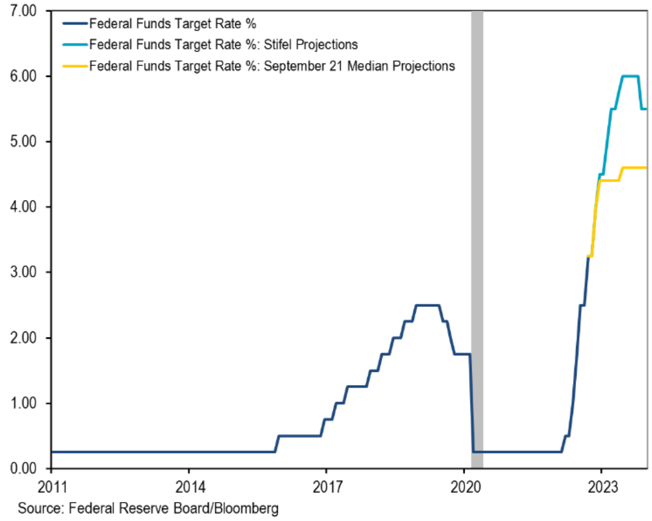
WHERE THE FED WAS RIGHT, WHERE THE FED WAS WRONG

While widely hailed as being behind the curve at the time of the first rate hike in March, there was a general agreement among the panelists that the Fed has redeemed itself with a rapid acceleration in the size of rate increases and clear communication that has kept inflation *expectations* well anchored. They are "*on the ball now*," one panelist declared.

In fact, one of the criticisms of the Fed's policy response during the 1970s was the lack of "*commitment*," as one panelist described it. That forced the market to lose confidence in the Fed's willingness or ability to raise rates high enough to slay the inflation dragon. And, because of that, inflation expectations became unhinged.

But while there are at least broader lessons to be learned from the past as both markets experienced a supply-side shock of sorts, there was a general agreement among participants that the Volcker Fed is a "*difficult*" or even an outright incorrect comparison to make relative to today's Fed. By the time Volcker stepped in as Fed Chair in 1979, inflation was already "*out of control*" and expectations for inflation had risen markedly. That being said, all panelists were in agreement that because today's economy is so very different from five decades prior, trying to draw a comparison or correlation to any earlier market action or reactions is less than beneficial.

EXPECTATIONS FOR INFLATION, RATES, AND THE ECONOMY



Source: Federal Reserve Board/Bloomberg

Panelists were in agreement we are not currently in recession, but in all probability will be in recession by the end of next year.

With the Fed's November Federal Open Market Committee meeting just five days away, the consensus remains for a fourth round 75-bps increase. For December, however, two of the panelists suspect the Fed will begin to soften its pace of rate increases with just 50 bps, while the remaining participant anticipated yet another 75-bps increase with the caveat "*should inflation remain elevated*."

The median consensus among the panelists for the Fed's terminal rate was 5.33%, with two in the camp of 5% and one anticipating a potential for 6%. Among those in the 5% camp, the rate pathway is an expected additional 125 bps (75 bps and 50 bps) in 2022, and 50 bps in 2023. While the relatively lower expectation for peak rates, those anticipating a more shallow level of federal funds also noted the likelihood of holding steady at this elevated 5% rate for some time.

And finally, as the Fed continues to raise rates, the majority of the panel was optimistic regarding the pathway for inflation reaching 2.5% to 3% within the next 6 - 12 months, with one suggesting a more extended timeline into 2024. Although in either case, acknowledging the tendency to perpetually underestimate price pressures, *all* concluded the risk to inflation is clearly and notably to the upside.

Lindsey Piegza
Ph.D., Chief Economist
piegzal@stifel.com

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