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MARKET
SIGHT LINES

The Federal Reserve's Dual Mandate is Askew: When Can the Fed Ease?

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The Federal Reserve (Fed)'s dual mandate is askew, with unstable prices (elevated inflation) and a very strong job market (more than maximum employment). And the Fed has painted itself into a corner by saying it will continue to raise rates aggressively and keep rates elevated until inflation cools and prices stabilize, feeling comfortable doing so given the strong job market. In response, market interest rates have risen, and stocks have fallen further.

In this week's Sight|Lines, we present how the Fed can ease monetary policy, which would likely lower interest rates and trigger a "relief rally" in equities.

IN SUMMARY: THE FED WILL SHIFT POLICY WHEN ITS DUAL MANDATE IS BALANCED

Given its aggressive hawkish actions and messaging, the Fed can shift policy only when the elements of its dual mandate are better balanced. This can be accomplished in one of two ways:

- First, there is evidence of much-improved inflation, a positive.
- Or second, tighter economic conditions quickly erode the strong job market and/or push the economy into a deep recession, possibly a negative.

DISCUSSION: DEFINING THE SIGNS OF IMPROVED INFLATION OR WEAKENED EMPLOYMENT

What might the Fed be looking at to see signs of improved inflation or weakened employment?

Improving Inflation

Here are some potential signs of improving inflation:

- *Wage Pressures Subside* – Wages are up 5.2% over the last year, greatly exceeding the annual growth rate of wages in the prior 10 years. More muted wage growth will ease inflationary pressures.
- *Food/Shelter/Core Goods Prices Ease* – Prices on food, shelter, and core goods are up meaningfully over the last year. A slowing growth rate, or even lower prices, will help bring inflation down.
- *Supply Chain Pressures Ease* – Supply chains have been challenged in the pandemic reopening. As we see improvements in the supply chain, like the availability and speedy delivery of key components globally, inflation should improve.

- *Inflation Expectations Fall* – The Fed focuses on inflation and inflation expectations, and such expectations, especially the consumer's, are well above the Fed's 2% inflation target. For example, the latest University of Michigan survey puts consumer inflation expectations at 4.6% over the next year. Lower inflation expectations will be a positive.
- *Inflation Cools* – The headline consumer price index (CPI) cooled in July and August at 0% and 0.1%, respectively. But core CPI, which excludes food and energy, remained elevated. The Fed will respond positively to lower CPI inflation and other measures like the personal consumption expenditures price index (PCE) published by the U.S. Bureau of Economic Analysis (BEA).

If we see signs of improving inflation, the Fed will be justified in pausing its hawkish shift, a positive.

Weakening Employment

As mentioned, while improving inflation would be a positive way for the Fed to find balance with its dual mandate, such a balance may result from weaker employment. Here are potential signs of weakening employment:

- *Job Quits Slow* – Workers are confident, and many more than usual are leaving jobs with the confidence of finding a better one. A slowdown in "quits" will be a sign of softer employment.
- *Initial Jobless Claims Rise* – Initial jobless claims have been low by historical standards. Higher levels will directly increase unemployment.
- *Unemployment to Job Openings Ratio Declines* – Currently, there are 1.9 jobs available for every unemployed person, so we'll expect to see this ratio decline back to the long-term average of about 0.6.
- Unemployment Above 4.4% – The Fed has projected unemployment to be 4.4% in 2023 and 2024, above the roughly 4% unemployment rate it considers "maximum employment." The Fed may shift policy if unemployment rises above the expected 4.4% level.
- *A Troubled Economy* – While we discuss various employment data above, a weakening employment environment could come with a troubled economy, such as a deep recession or the strong prospect of one in the event of an unexpected shock or severely negative financial conditions. We believe the Fed will ease its monetary policy in such an environment.

With weakening employment or a troubled economy, the Fed will likely ease. Helpful, but a negative.

CONCLUSION

The Fed's dual mandate is askew, with unstable prices and a very strong job market. Since the Fed has painted itself into a corner by saying it will stay aggressive, Fed officials watch the dual mandate carefully before shifting policy. This can be accomplished in two ways, either by improving inflation or weakening employment. The Fed and investors alike are monitoring both as the Fed tries to balance its dual mandate.

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