

Economic Update

Can the Fed Thread the Needle?

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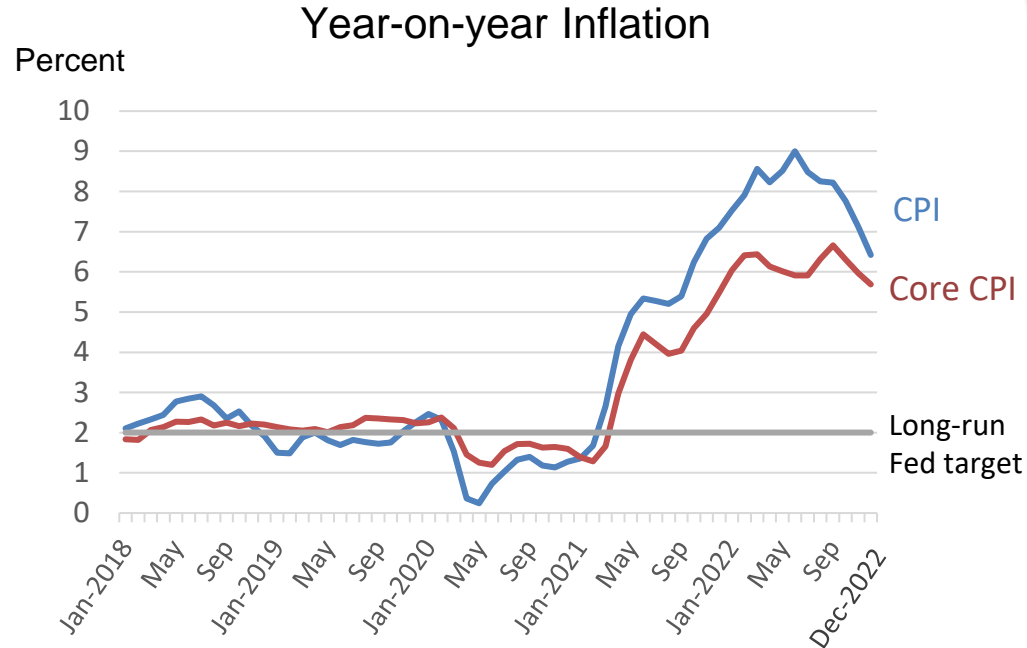
January 2023

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Inflation dominates everything

- Inflation has proven maddeningly persistent
- It has begun to ease, but remains very high
 - The highest inflation rates in four decades
- Due both to strong demand and some lingering supply constraints

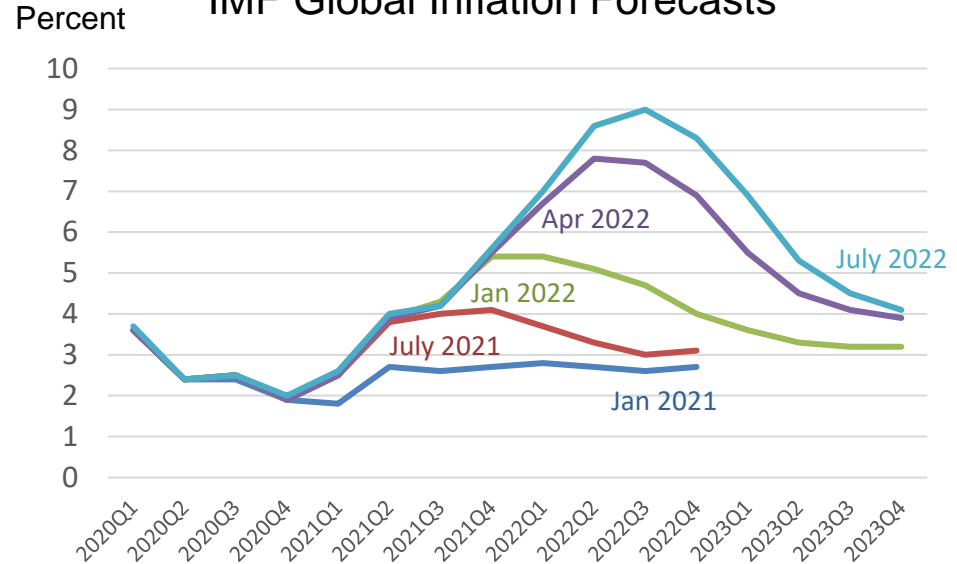


Source: US Bureau of Labor Statistics.
Core inflation excludes volatile food and energy.

Not just a US surprise

- Globally, inflation has continually exceeded forecasts
- Made worse in foreign countries by the sharp weakening of their currencies against the dollar
 - Weaker currencies means they are “importing” inflation via higher import prices
 - Possible developing country debt crises

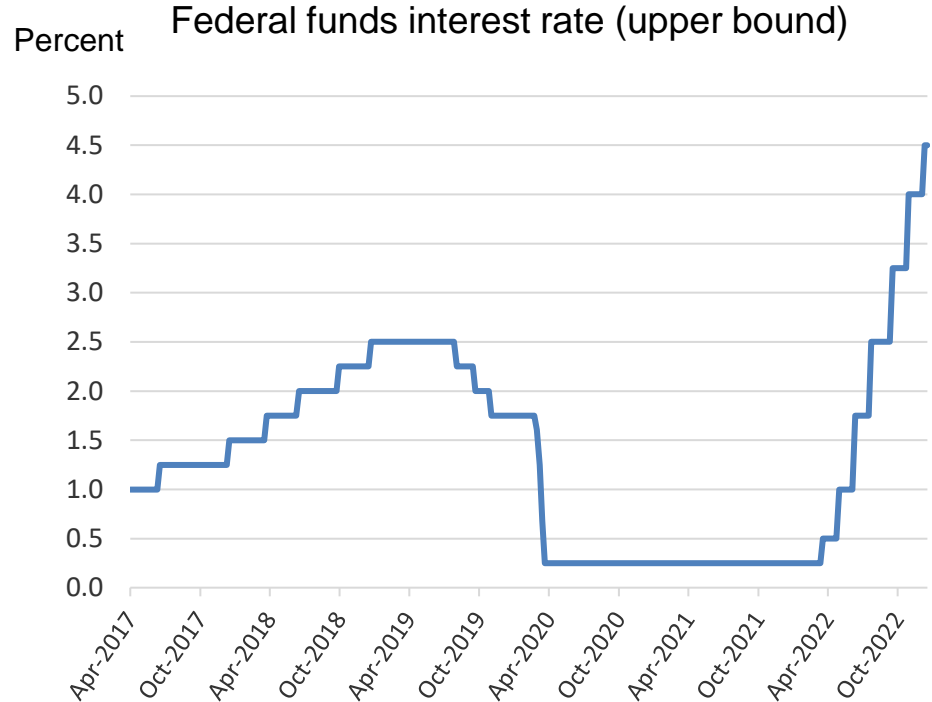
IMF Global Inflation Forecasts



Source: International Monetary Fund, World Economic Outlook.

Fed has raised rates rapidly

- The Fed fights inflation by raising interest rates to discourage borrowing and spending
- Fed has raised rate for seven meetings in a row
 - Some were “super-sized” three-quarter point hikes
 - Most rapid increase in interest rates since the early 1980s
- Mortgage rates soared about 7% before a small pullback



Source: Federal Reserve via <https://fred.stlouisfed.org/>

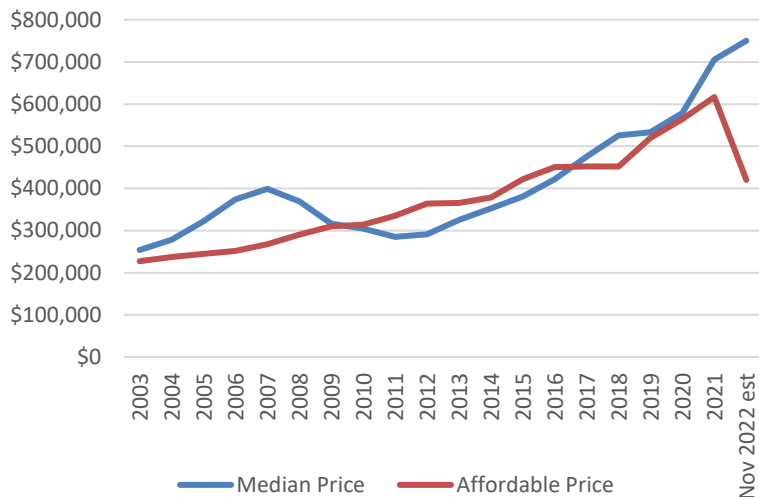
The Big Question:

- The Big Question:
 - **Can the Fed get inflation under control without causing a recession?**
 - Can it thread the needle?

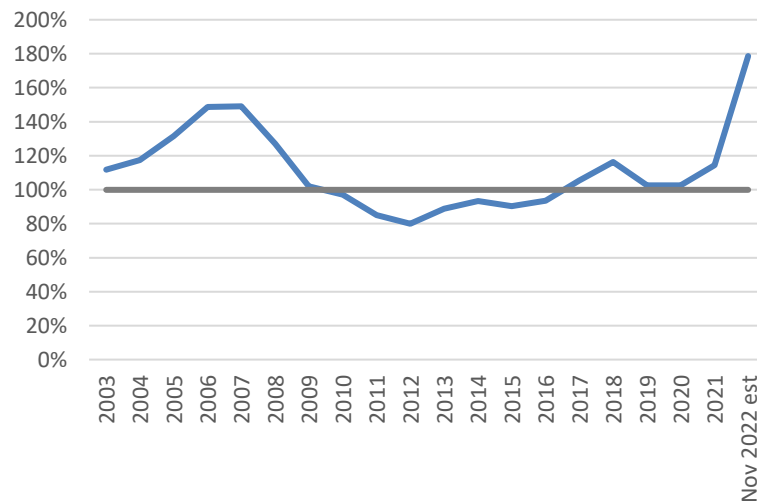
- Where are we already seeing effects of Fed tightening?

Housing: Affordability has crashed

Seattle Median Home Price and Affordable Price

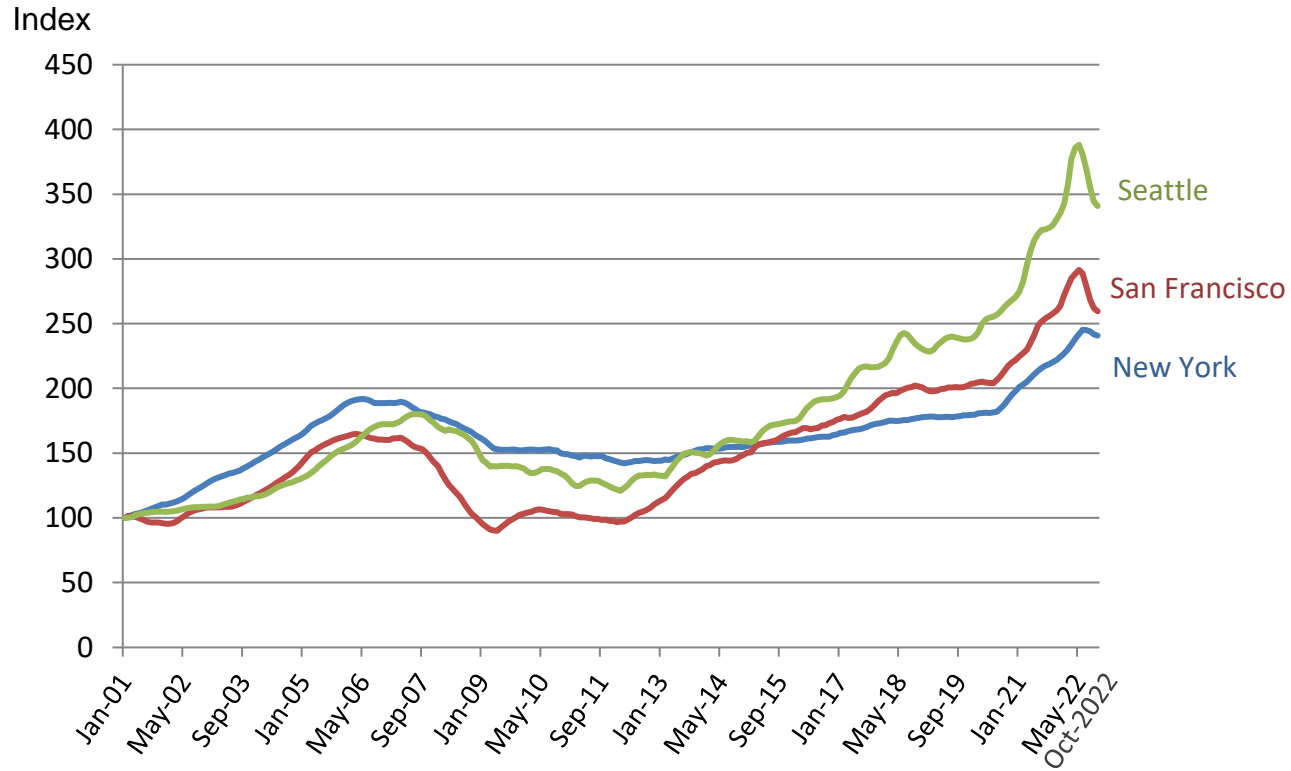


Seattle Median Home Price as A Percent of Affordable Price



Sources: realtor.com; S&P Dow Jones; US Census Bureau; Freddie Mac; bankrate.com; smartasset.com; author's calculations. Some underlying figures for 2021-22 are estimates.

Home prices have begun to turn

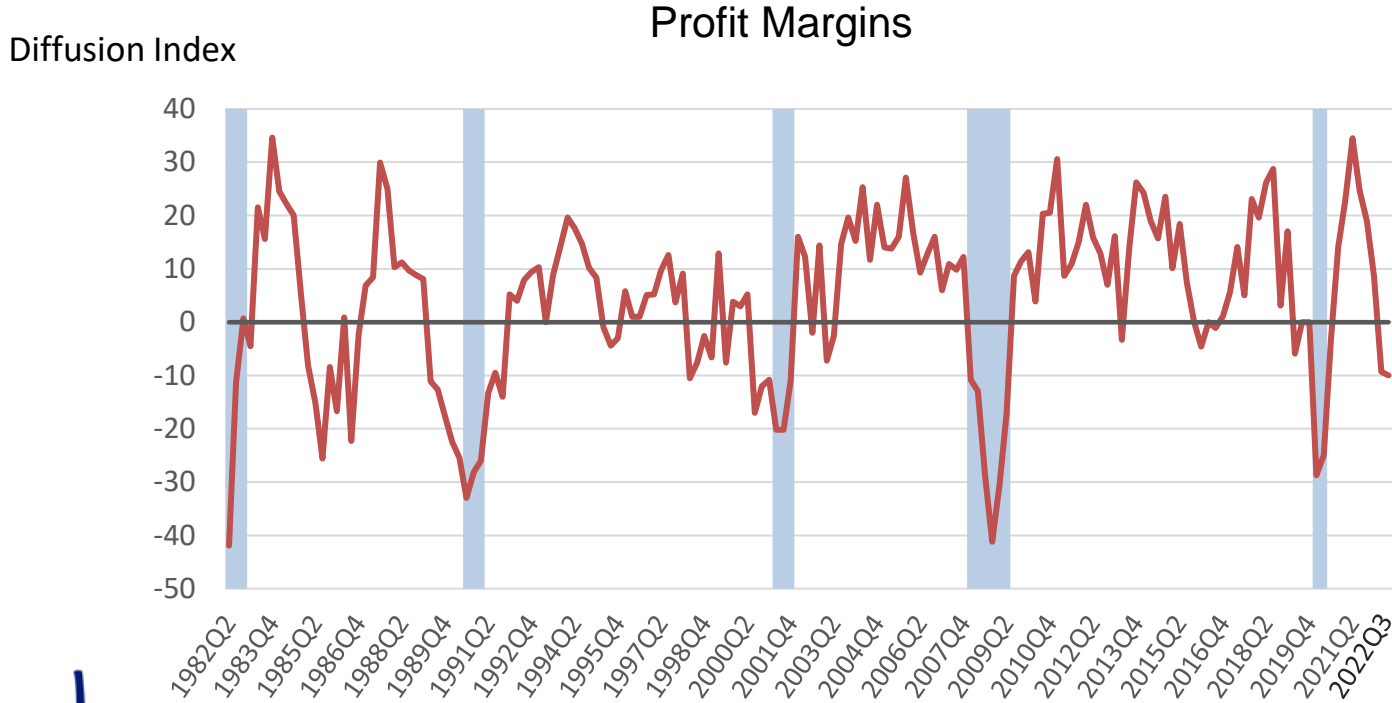


Source: Case-Shiller data, S&P Dow Jones

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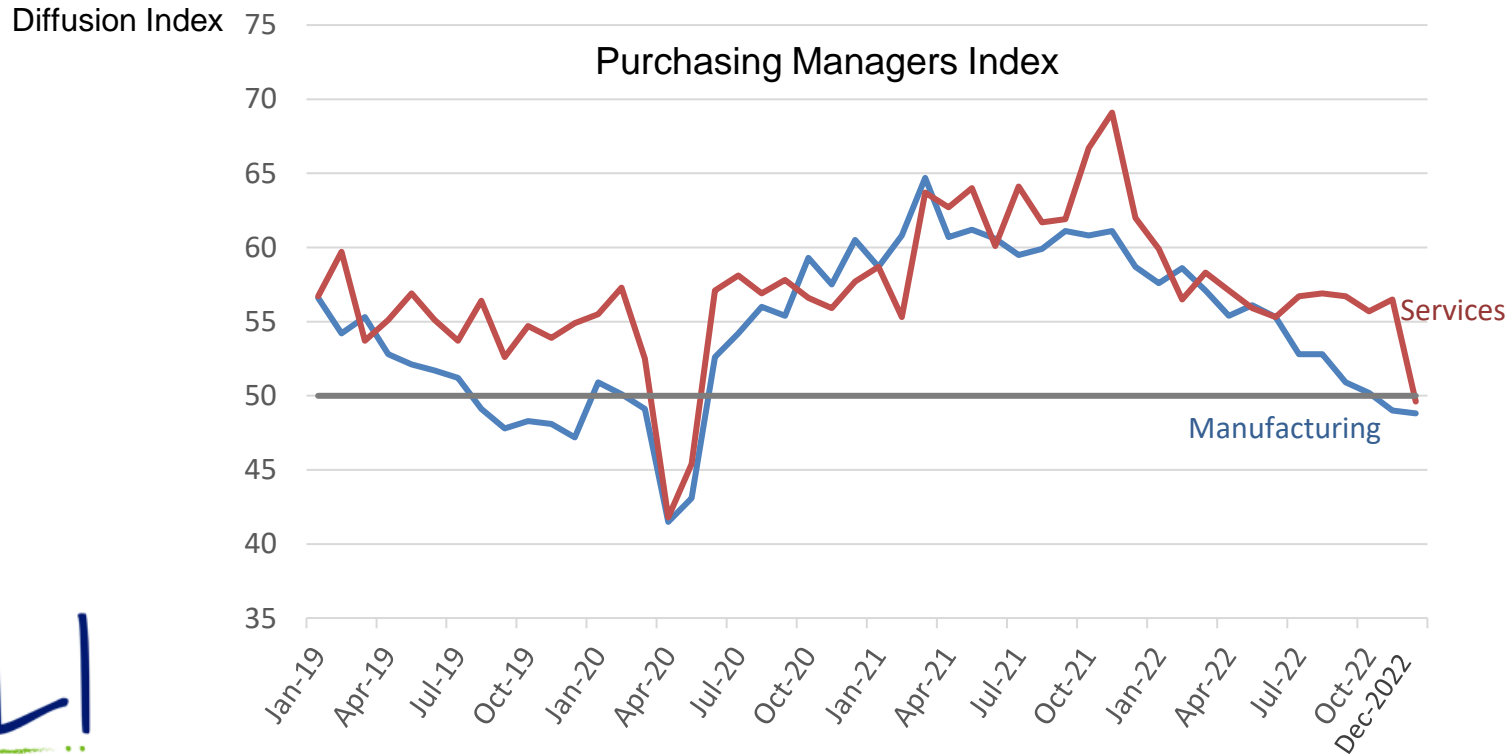


Signs of broader slowing? Profits falling



Source: National Association for Business Economics *Business Conditions Survey*
Diffusion index is the difference between respondents reporting expanding margins and those reporting contracting margins
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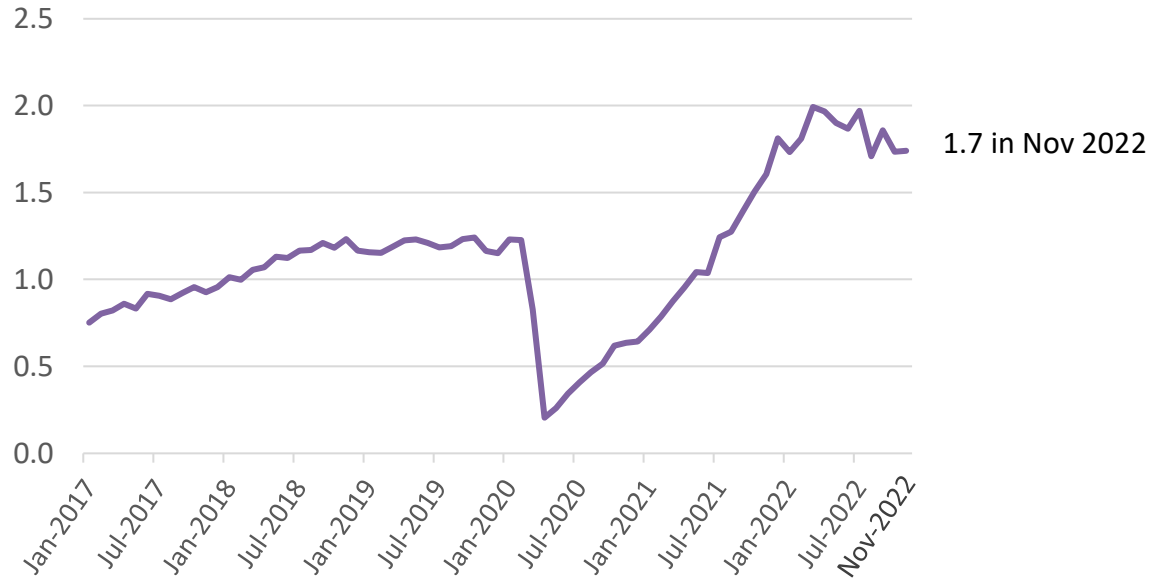
Signs of broader slowing? Both manufacturing and services are now contracting



Labor markets remain strong. Too strong?

- The US labor market remains very tight
 - The number of job openings per unemployed worker is nearly twice its “normal” level
 - The unemployment rate is a very low 3.5%
 - Lowest since Feb 2020
- Wage gains have been rapid
 - If falling short of inflation
- The pace of corporate hiring and wage gains are gradually decelerating

Job Openings per Unemployed Worker

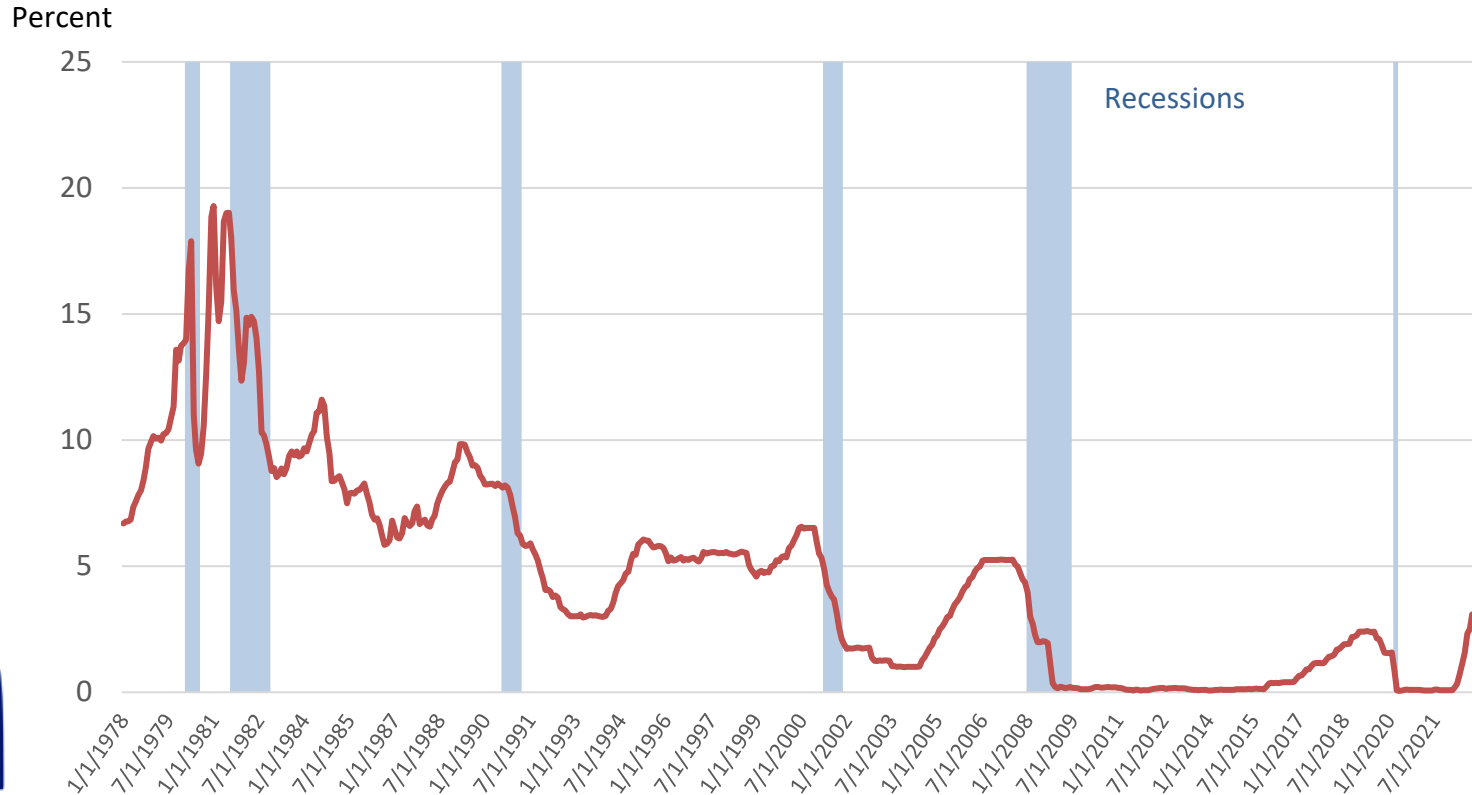


Source: US Bureau of Labor Statistics

The Outlook: Can the Fed engineer a soft landing?

- Soft landing
 - Inflation brought back to acceptable level—clearly moving toward 2% long-run target...
 - ...without causing a recession—a broad-based contraction in economic activity
- Largely comes down to
 - How persistent is high inflation
 - And so how hard the Fed needs to stomp on the economy
- Fed's track record is poor
 - Most times they have tightened sharply, a recession has followed

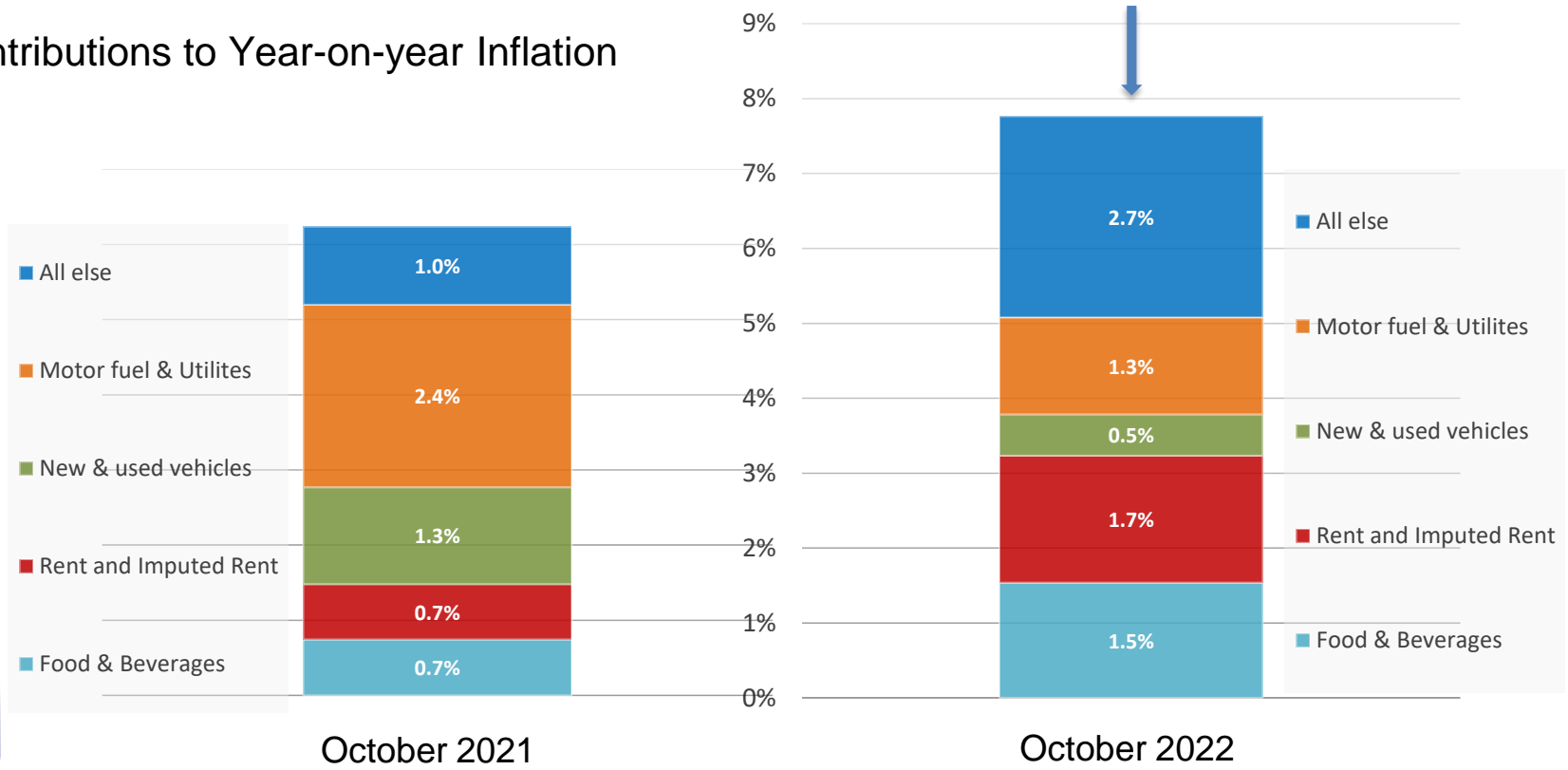
The Fed's track record is poor



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Transitory inflation is fading—now core is concern

Contributions to Year-on-year Inflation



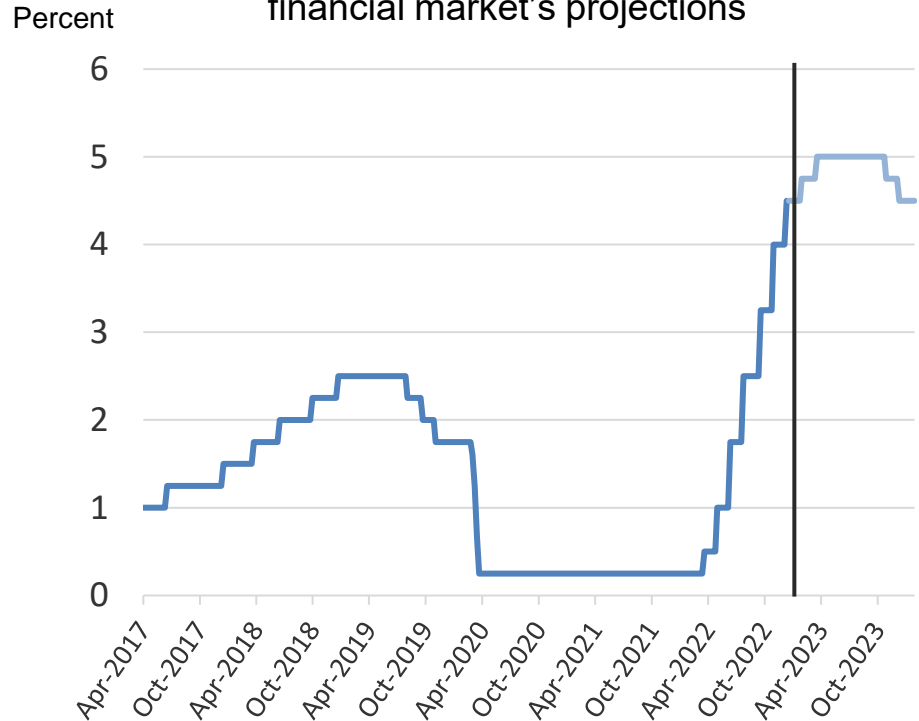
Fed has a little further to go

- Fed has further to go in raising rates
- And rates will likely be held at a relatively high rate for some time
 - Until there are clear signs that high inflation is over
 - The labor market “shows only tentative signs of rebalancing, and wage growth remains well above levels that would be consistent with 2 percent inflation over time,”

–Jerome Powell in November

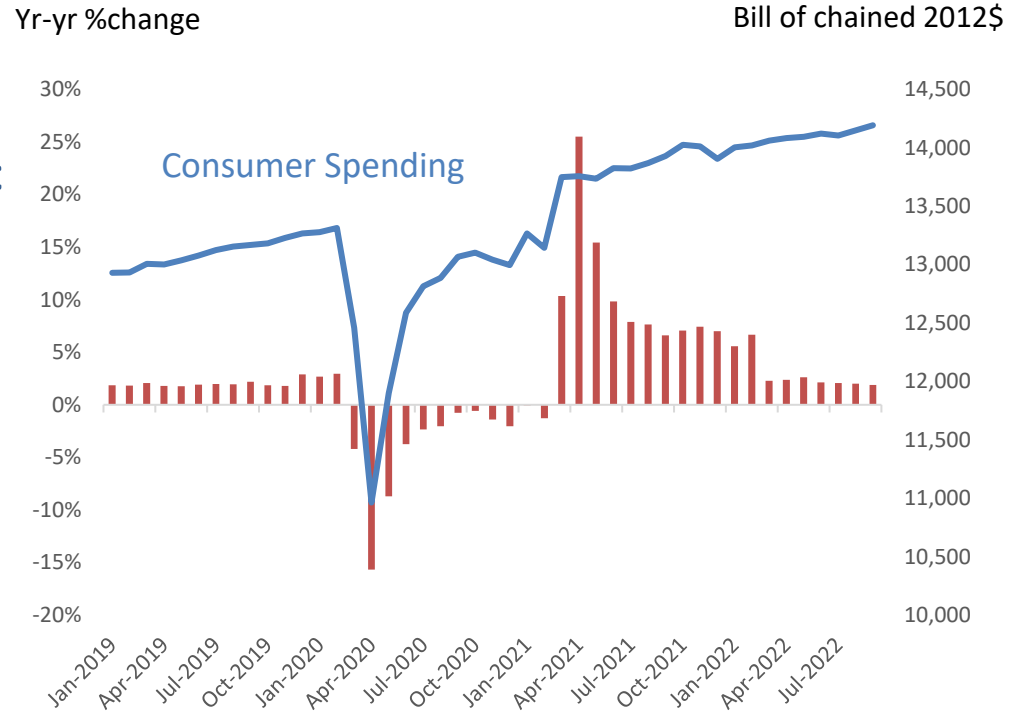


Federal funds interest rate (upper bound) and financial market's projections



Spending momentum has dialed back

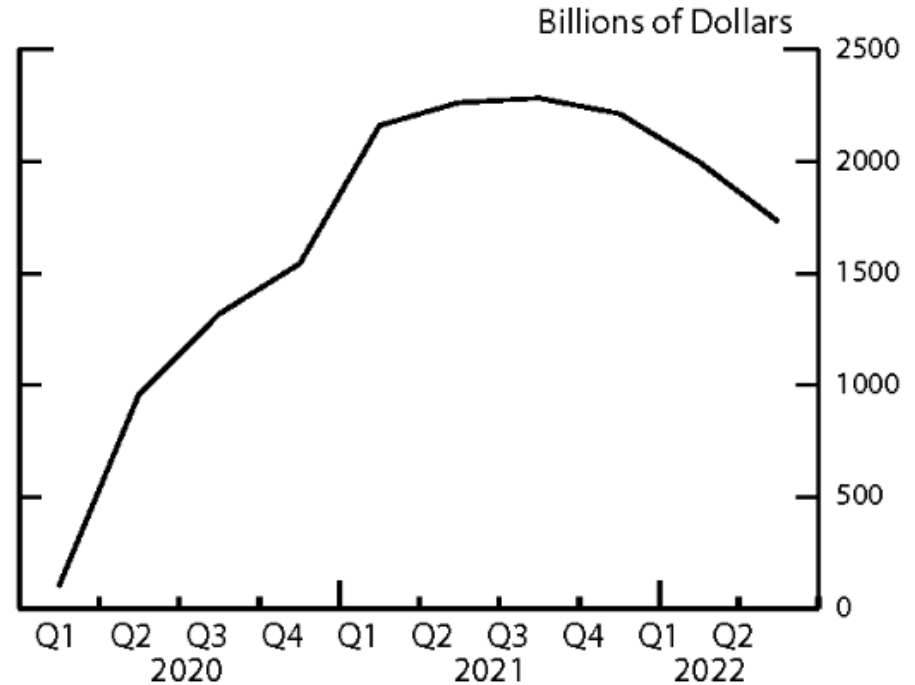
- Consumer spending has slowed after a post-pandemic recovery surge
- It is still expanding at a moderate pace



Households still have saved money

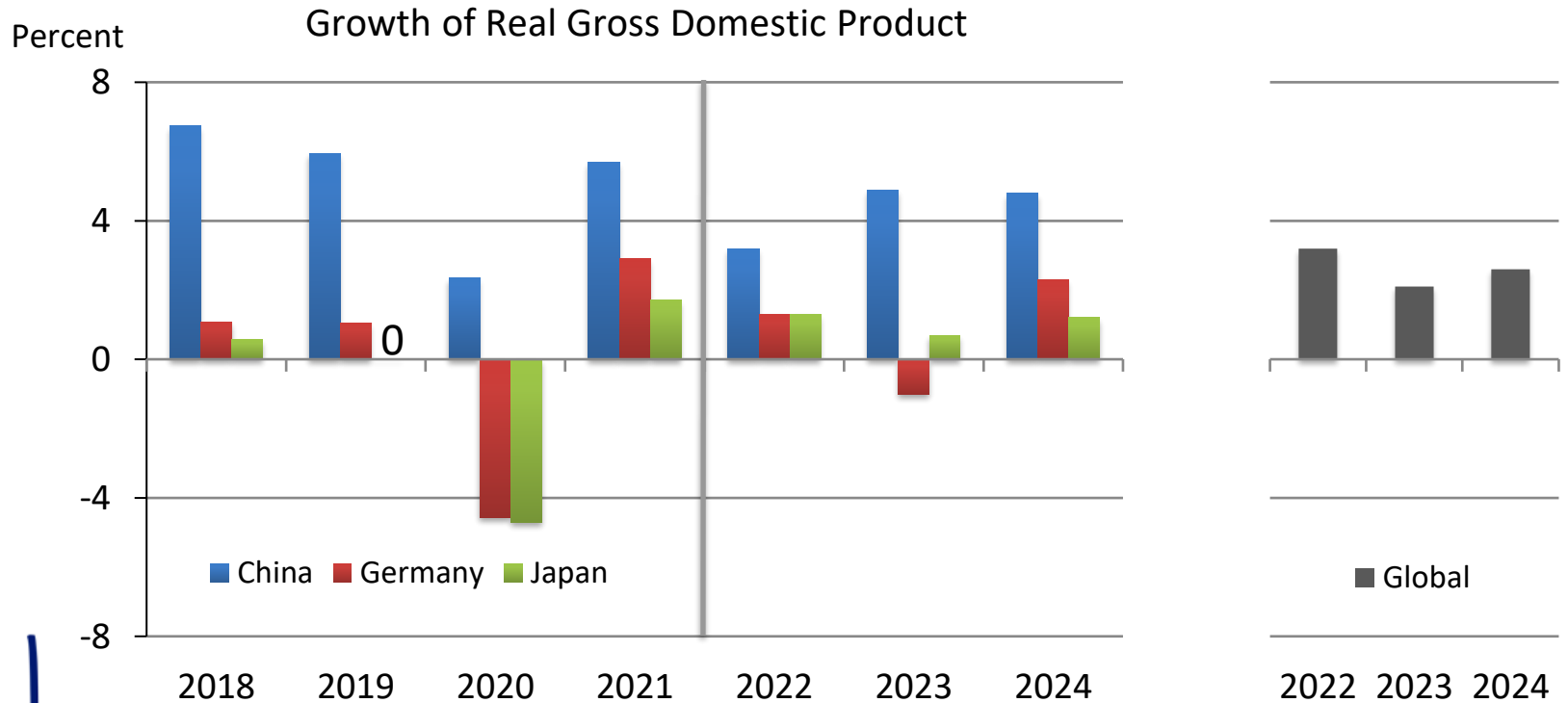
- Consumers are pessimistic about the economic outlook
- But they are only slowly working down excess savings from the pandemic
 - Huge fiscal support
 - Nothing to spend it on until now
- How long will this sustain healthy consumer spending?
 - Holiday spending was lackluster
 - Black Friday sales were up 4-5%; but much lower than 2021 after adjusting for inflation

Stock of excess savings



Source: [Federal Reserve](#)

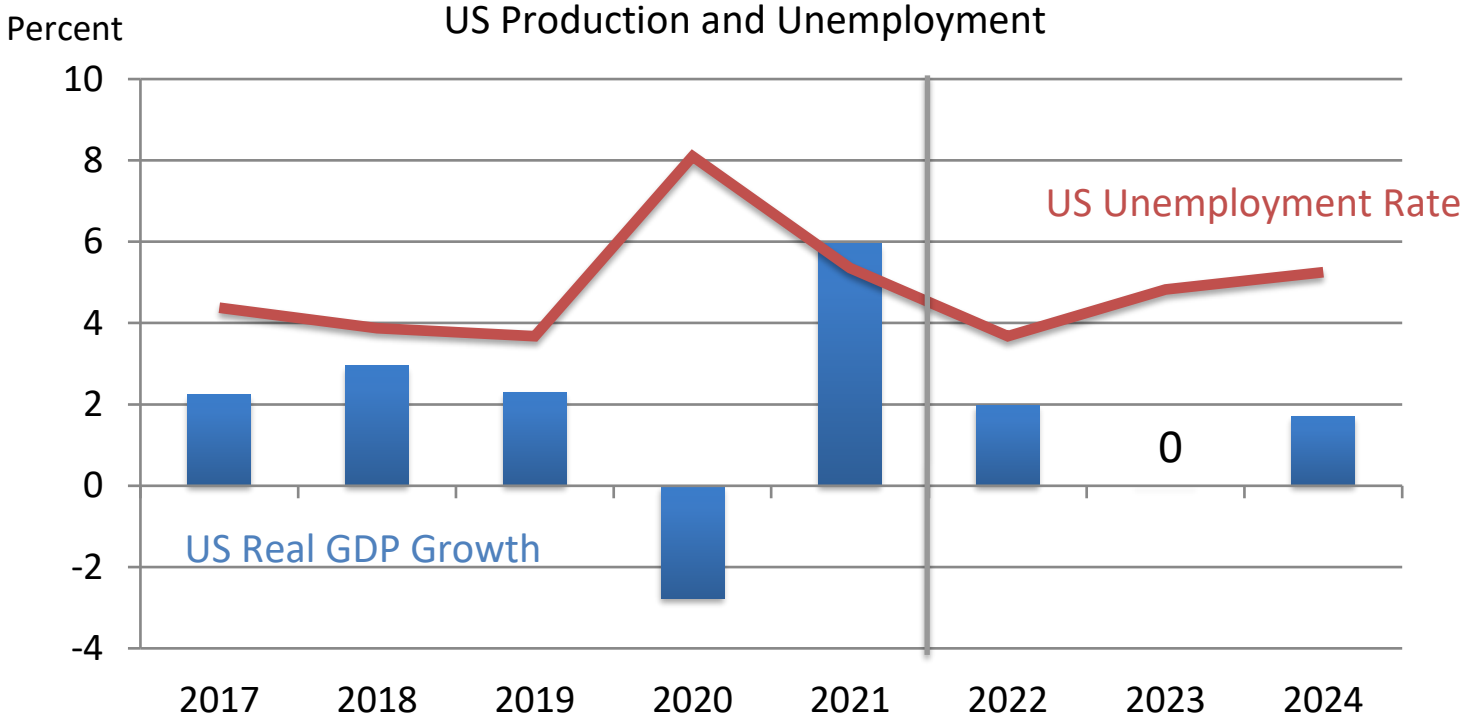
Outlook: Ukraine, inflation, 0-COVID clobber global growth



Source: For Japan, UHERO 22Q4 forecast. Others, various sources.

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Outlook: US recession means no growth in 2023



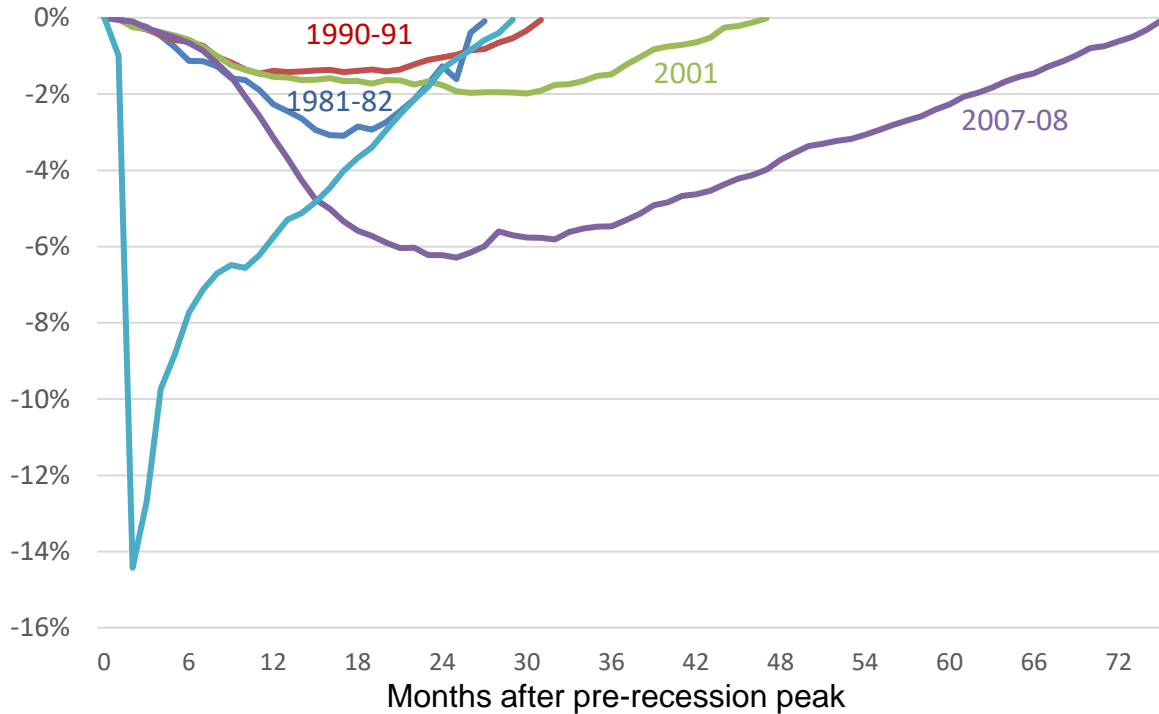
Source: UHERO fourth quarter 2022 forecast

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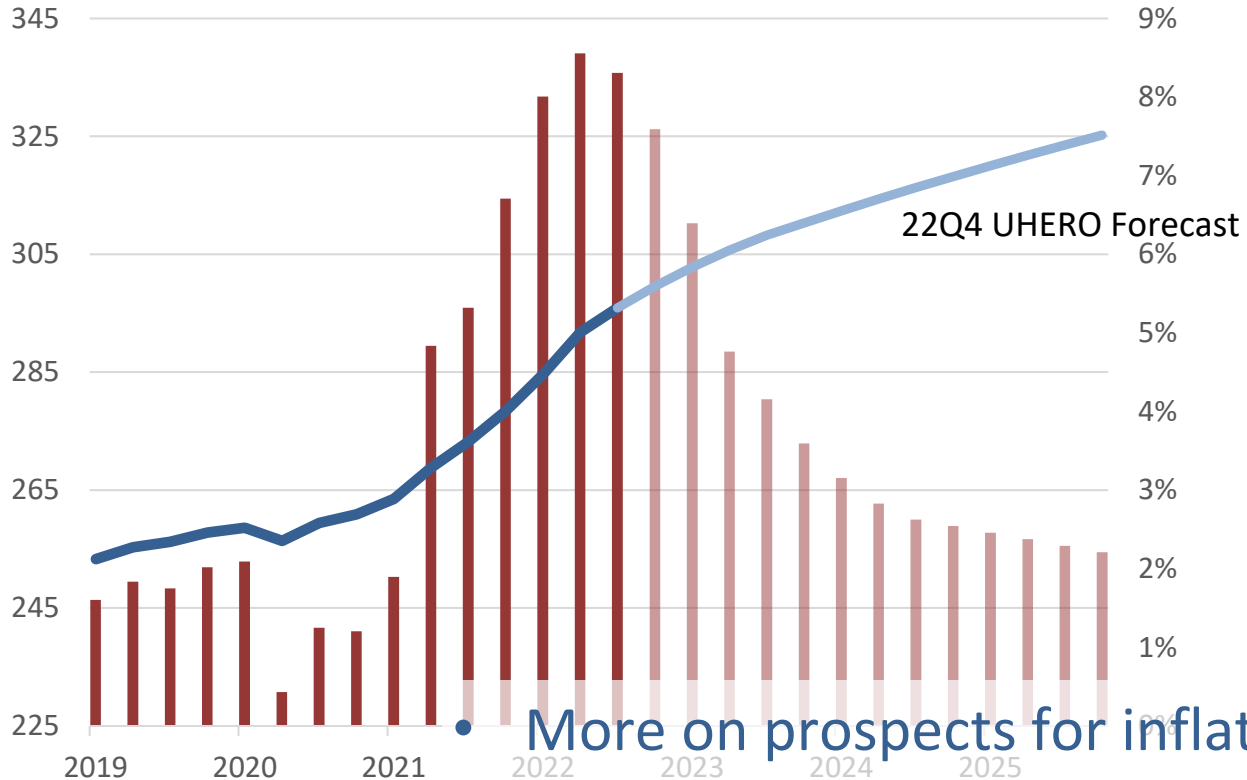
Recession will look more like “typical” ones

Percent drop
in job count



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Inflation will come down quickly



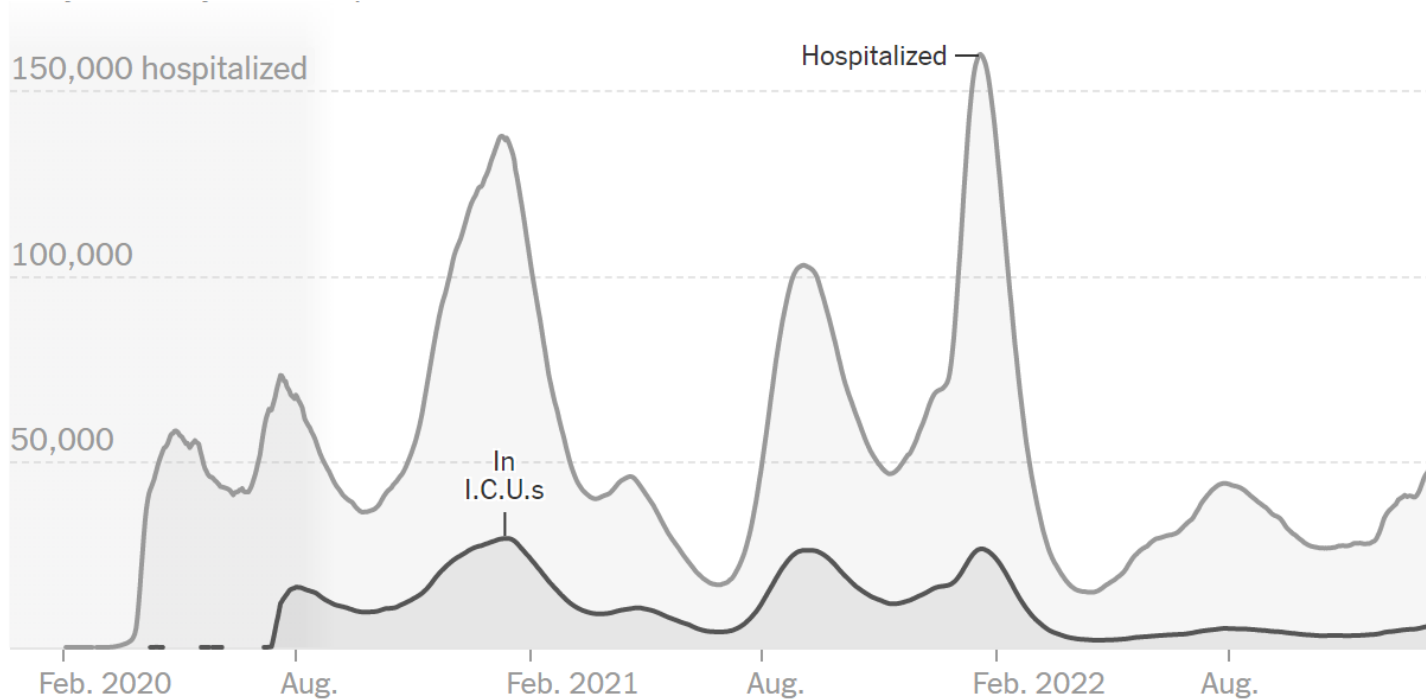
More on prospects for inflation and growth in Friday's presentation

Other factors that might matter?

- Midterm election results?
 - ~~Hard to see how they will have much of an effect~~
 - Does not change the balance of power significantly
 - Republican House has only a razor-thin majority
 - ~~Might~~ But significantly increases the risk of fiscal cliffs?!
- COVID-19?

Is COVID-19 still a concern?

United States Hospital Resources Used



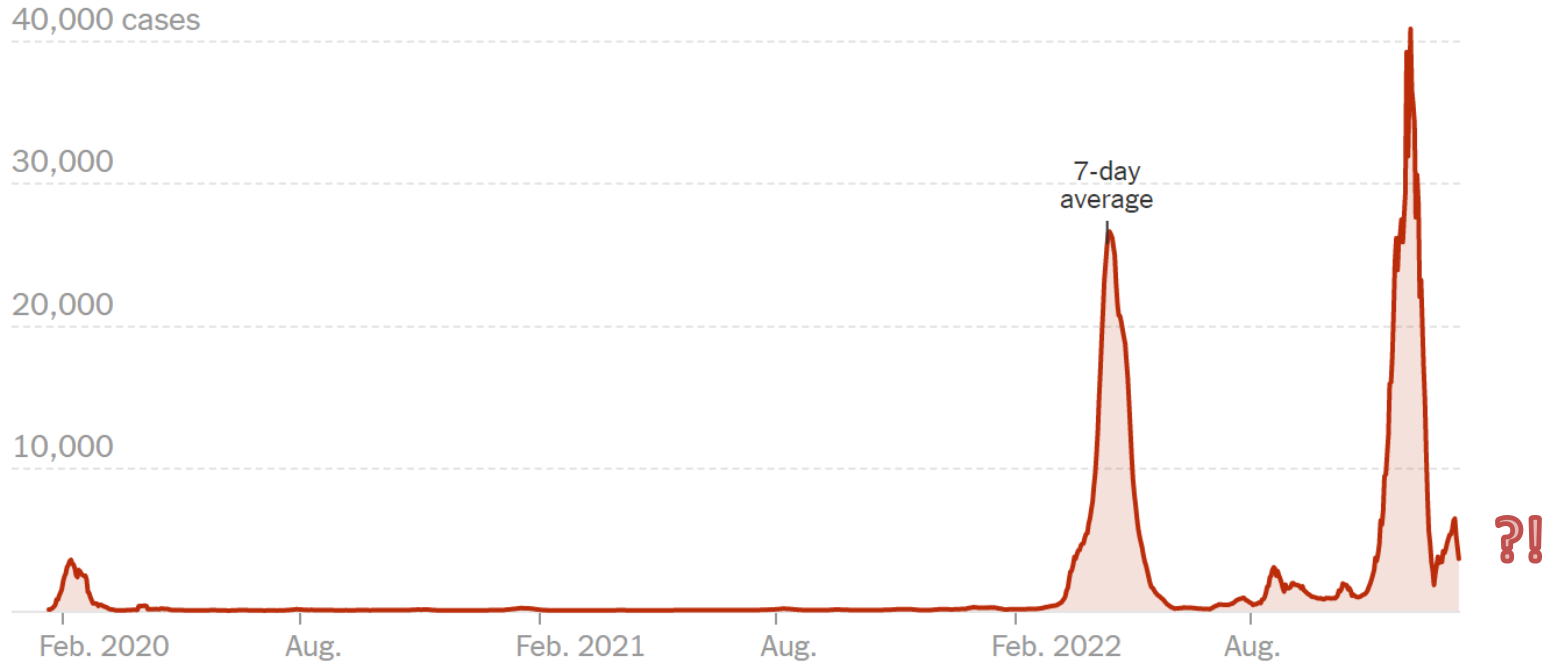
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Source: New York Times, through 8, 2023



In China? Is a new COVID crisis underway?

New Reported Cases



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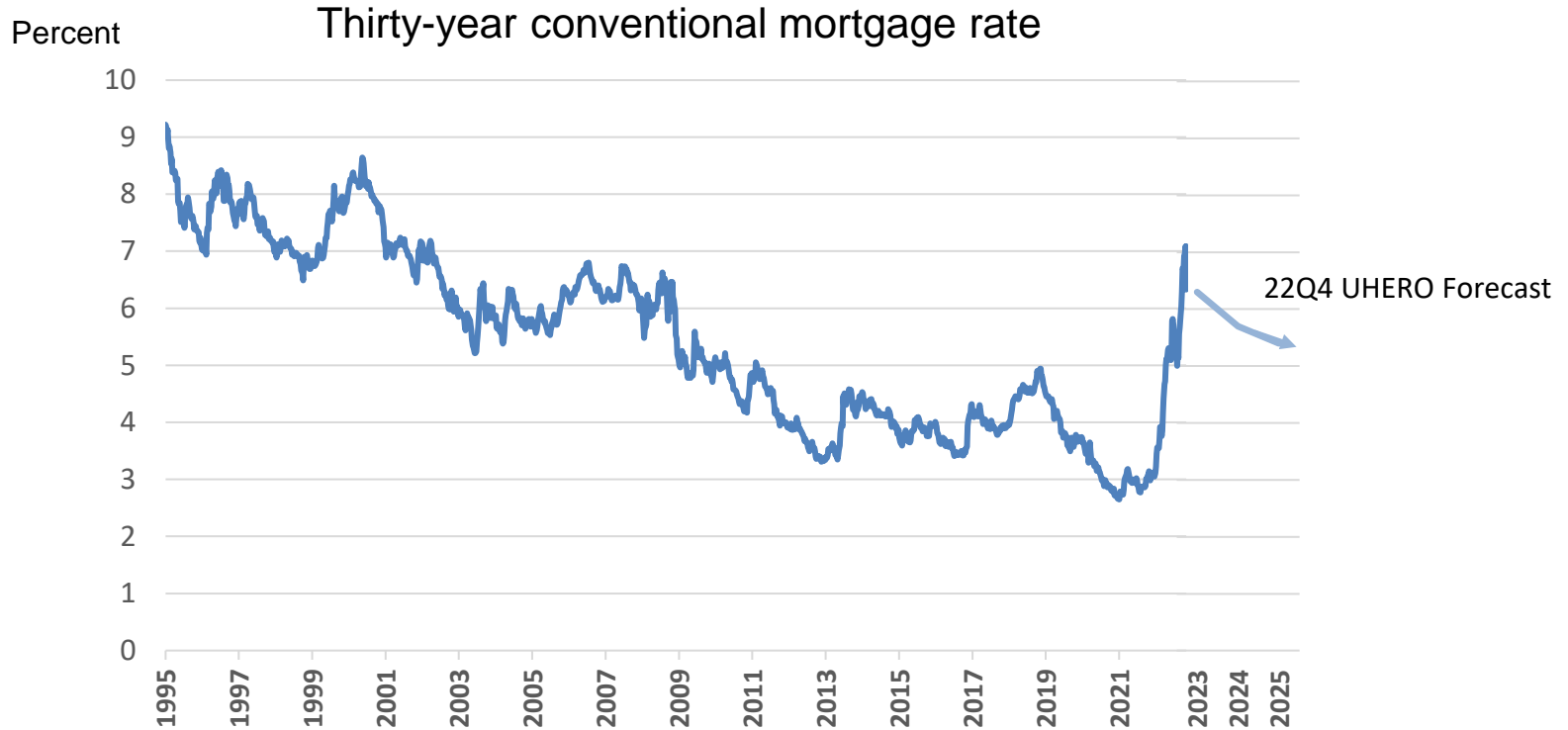
Source: New York Times from Chinese Data

Challenges for financial institutions

As mortgage rates surged, lending tanked



Mortgage rates will take time to recede



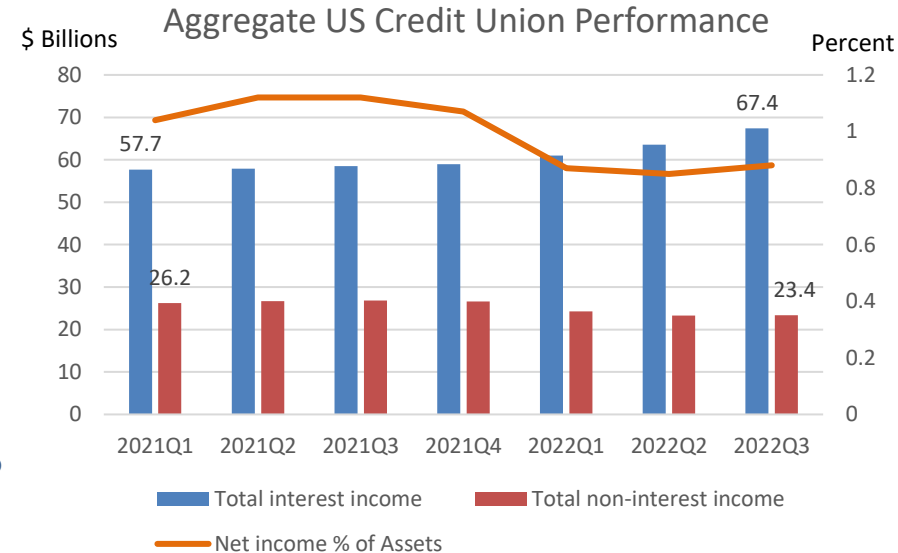
Source: Freddie Mac via FRED data site, UHERO.

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Financial markets and institutions

- Challenges for credit unions
 - Mortgage lending has collapsed
 - Higher loan spreads are offsetting losses in non-interest (fee) income
 - Net income has fallen a bit
 - Will auto lending recover?
 - Defaults are very low, but.
- For financial markets
 - High volatility likely to continue
 - Stock market recovery will come, but when?
 - Housing sector may be more vulnerable than many believe
 - But no 2008-style meltdown is likely



NCUA Quarterly Data Summary reports

Uncertainties

- What could go right?
 - The Fed could luck out. Just enough tightening to reduce demand and price pressures
- What could go wrong?
 - The “Long and variable lags” of monetary policy impact mean the Fed overreacts (as usual)
 - The global downturn is more severe
 - Bigger drop in spending, investment, employment
- In any event, the path ahead will be challenging.

Thank you!

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