Economics

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The Great Escape

Will the Fed Be Able to Wring Out Inflation Without a Recession?

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Summary

Storm clouds have gathered on the horizon for the U.S. economy. An inflation shock that began a year ago has proved more severe and long-lasting than originally anticipated. The fallout from the Russia-Ukraine conflict has poured additional fuel on the inflation fire. In response, the Federal Reserve has become increasingly hawkish as it strives to regain control of price growth. The latest dot plot signaled the median FOMC participant believes it will be necessary to take the fed funds rate above the "neutral" longer-run rate by next year. In other words, monetary policy is not only poised to become less accommodative, but to become outright restrictive. The yield curve has flattened considerably; the spread between the 2-year and 10-year Treasury note yields is just 24 bps at present.

Yet, FOMC members generally appear to think that inflation can be guided back toward target without undermining economic growth in a meaningful way. The median FOMC forecasts for real GDP growth from 2022-24 are all above the median potential growth estimate of 1.8%. Similarly, the FOMC generally expects the labor market to be essentially as tight over the next few years as it projected in December despite 112.5 bps of additional tightening through 2023.

Is it possible to pull off such a soft landing whereby the FOMC tightens monetary policy at a rapid pace, inflation comes down materially but economic growth and the labor market are largely unharmed? We believe the answer is yes, but possible and probable are two very different terms. *The U.S. economy is currently in a vulnerable position. Although that does not make a recession inevitable, it does suggest that the odds of a contraction are elevated.*

The U.S. economy is not in immediate danger of entering a recession, in our view. Our preferred econometric model for predicting a recession currently estimates just a 1% probability within the next two quarters. There is plenty of scope for economic growth to slow without outright contracting. Real GDP growth was 5.6% year-over-year in Q4-2021 and the economic data through the first quarter have been reasonably solid as well. Employment gains have topped expectations, real consumer spending appears poised to grow at a solid rate, and both current production and new orders are expanding at a healthy clip.

That said, the risk of a recession further out looks materially higher in our view. Today's environment leads us to believe recession risks are unusually elevated; *we put the odds of the U.S. economy contracting at some point between now and the end of 2023 at 30%.* Our base case remains that the Fed tightens policy further over the next year or two without generating a recession. Admittedly, the path to economic growth settling nicely back to trend and unemployment being more or less unchanged is narrow and will require a number of dynamics around spending and supply factors unfolding in the Fed's favor. But economic outcomes exist across a spectrum. We see a significant likelihood that a technical recession is avoided, but growth slips below trend and the labor market treads water. That, however, may require living with above-target inflation somewhat longer if the FOMC re-weights its priorities as economic growth and the labor market look shakier.

What Will It Take for the Fed to Wring Out Inflation?

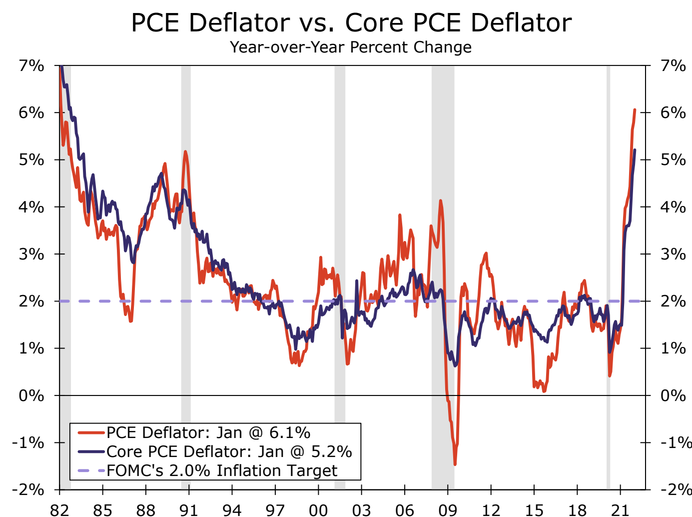
Reigning in inflation is unlikely to be easy.

The U.S. economy is not quite two years removed from the "official" end of the COVID-induced 2020 recession. More informally, real GDP only recovered to its pre-pandemic peak last summer, and the unemployment rate has not quite reached its February 2020 level. Yet, the "R-word" suddenly has crept back into news headlines. Why have fears about a recession resurfaced so soon after the previous one ended?

In short, the U.S. economy is currently in a vulnerable position. Although that does not make a recession inevitable, it does suggest that the odds of a contraction are elevated. The highest inflation in 40 years has the Fed firmly focused on its price stability mandate, but reining in inflation is unlikely to be easy. The Consumer Price Index (CPI) reached 7.9% in February and is likely to climb even further over the coming months. The Fed's preferred measure of trend inflation, the core PCE deflator, is up 5.2% year-over-year (Figure 1). Price hikes have grown more widespread, making momentum difficult to break. Nearly three-quarters of items in the CPI are up more than 3% year-over-year, while the median CPI has risen at its fastest pace in records dating back to the early 1980s in each of the past two months.

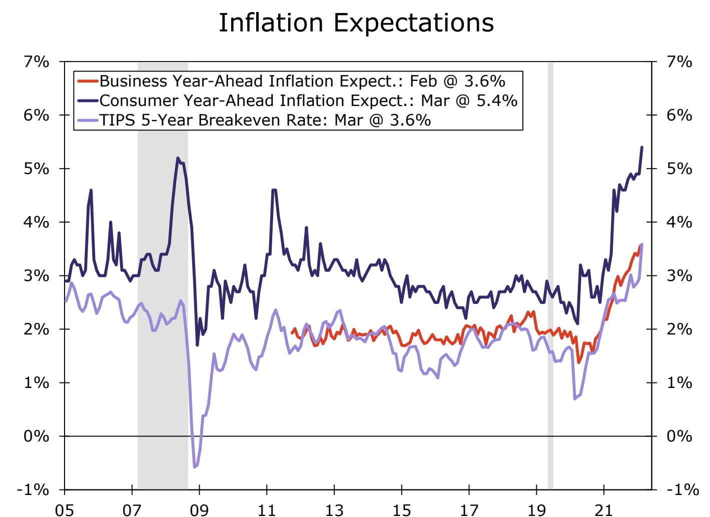
The shock to commodity prices imparted by Russia's invasion of Ukraine has only added to the list of reasons eye-popping inflation is not going away quickly. Short-term inflation expectations among consumers, businesses and markets have all shot higher to multi-decade or record highs, but longer-term inflation expectations are also on the move and signal above-target inflation is increasingly at risk of becoming entrenched (Figure 2).

Figure 1



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 2

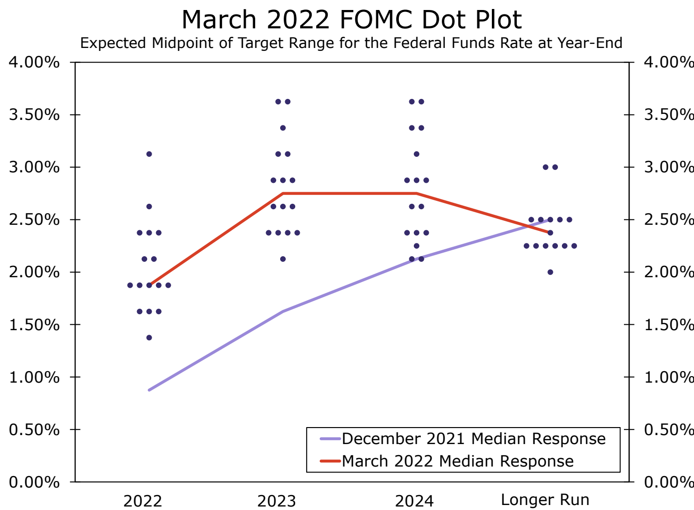


Source: Bloomberg Finance L.P., Atlanta Fed, University of Michigan and Wells Fargo Economics

Monetary policy is not only poised to become less accommodative, but to become outright restrictive.

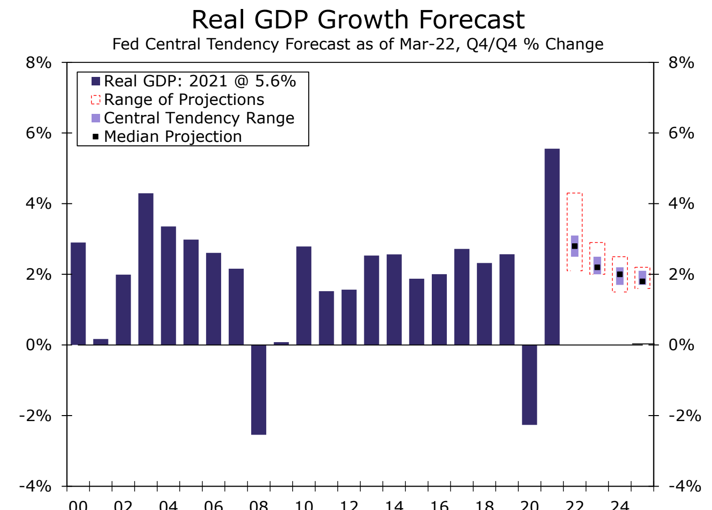
Against this backdrop, the Fed is starting to mount a more robust response to drive inflation down. The latest dot plot signaled the median FOMC participant believes it will be necessary to take the fed funds rate above the "neutral" longer-run rate by next year (Figure 3). In other words, monetary policy is not only poised to become less accommodative, but to become outright restrictive. Yet, FOMC members generally appear to think that inflation can be guided back toward target without undermining economic growth in a meaningful way; the median forecasts for real GDP growth from 2022-24 are all above the median potential growth estimate of 1.8% (Figure 4). Similarly, the FOMC generally expects the labor market to be essentially as tight over the next few years as it projected in December despite 112.5 bps of additional tightening through 2023.

Figure 3



Source: Federal Reserve Board, Bloomberg Finance L.P. and Wells Fargo Economics

Figure 4



Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Economics

Is it possible to pull off such a soft landing whereby the FOMC tightens monetary policy at a rapid pace, inflation comes down materially but economic growth and the labor market are largely unharmed? We believe the answer is yes, but possible and probable are two very different terms. The likelihood of a policy misstep in an environment like this is much higher than usual, and we believe there are good reasons to be skeptical of this relatively sanguine outlook from the FOMC. Bond markets also seem dubious that rates will climb that far before inflicting more material pain on growth. The spread between the yield on the 2-year and 10-year Treasuries has narrowed to just 24 bps. What would a soft landing look like, and how would it contrast with a hard landing?

There are good reasons to be skeptical of the relatively sanguine outlook from the FOMC.

Recession Odds

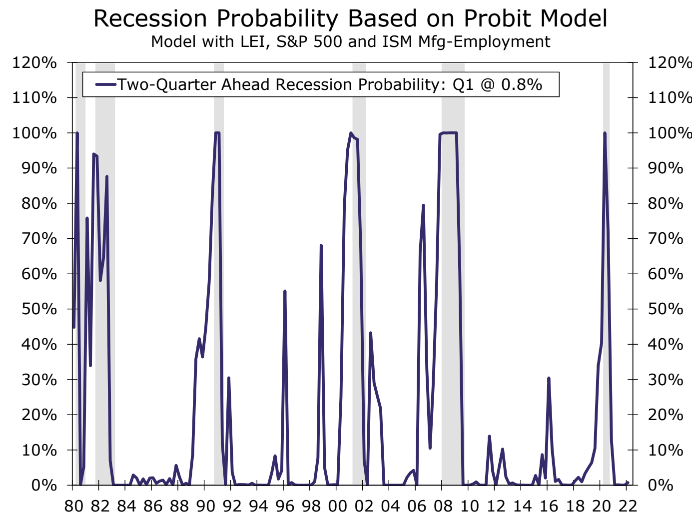
Predicting a recession is seldom easy. Recessions tend to come about from an exogenous shock—like a global pandemic—an imbalance in the economy—such as elevated debt—or some combination of the two. Even when the potential source for a recession is clear, predicting *when* the catalyst will tip the scales is not exactly simple.

The task of identifying *what* may drive the economy into a recession looks somewhat easier today. The Federal Reserve's plans to take interest rates into restrictive territory clearly present one potential catalyst for a recession. The commodity price shock caused by Russia's invasion of Ukraine presents another, as higher oil and food prices effectively act as a tax on consumers. However, there is plenty of scope for economic growth to slow without outright contracting. Real GDP growth was 5.6% year-over-year in Q4-2021 and has scope to weaken before slipping into recession territory. The economic data through the first quarter have been reasonably solid as well. Employment gains have topped expectations, real consumer spending appears poised to grow at a solid rate, and both current production and new orders are expanding at a healthy clip.

Our preferred recession probability model based on the Leading Economic Index, which we like due to its lack of false signals in real time, currently puts the probability of recession in the next two quarters at a scant 1% (Figure 5). Similar models that rely more heavily on financial market variables, such as the spread between 3-month and 10-year Treasury yields or equity prices and the VIX, signal a higher probability—18% and 14%, respectively—but that is still not particularly elevated in a historical sense (Figure 6). All told, an average of our eight probit models described in detail in a previous report predicts the chance of a recession in the next two quarters at a rather low 10%. Therefore, even with the prospect of the FOMC lifting rates at the fastest pace since the mid-2000s this year, the economy does not appear to be in much *immediate* danger.

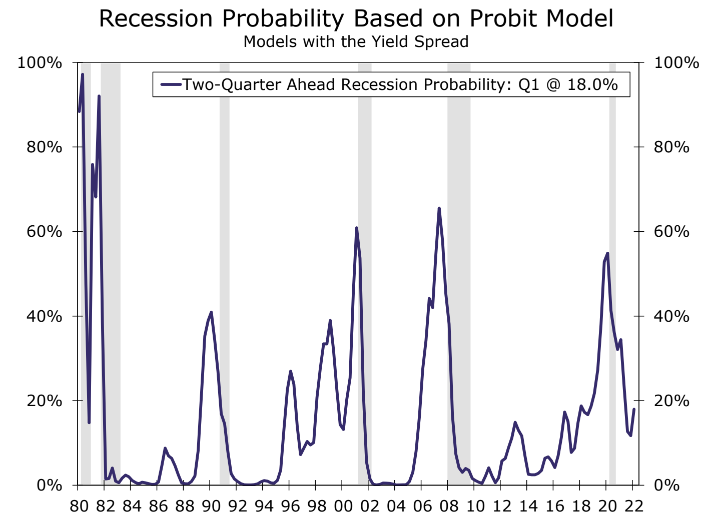
The economy does not appear to be in much immediate danger of a recession.

Figure 5



Source: Wells Fargo Economics

Figure 6



Source: Wells Fargo Economics

As is usually the case in forecasting, however, the outlook becomes murkier further out. Yes, the economy seems to have the fortitude to withstand higher rates and inflation over the next six months or so, barring another exogenous shock. But the lagged effect of higher rates, the ongoing inflation shock and the withdrawal of fiscal support present tangible risks to the outlook beyond the next two quarters. When looking beyond the near term, what are the vulnerabilities, and what will it take to execute a soft landing?

Jay Stark: The Man Who Passes the Sentence Should Swing the Sword

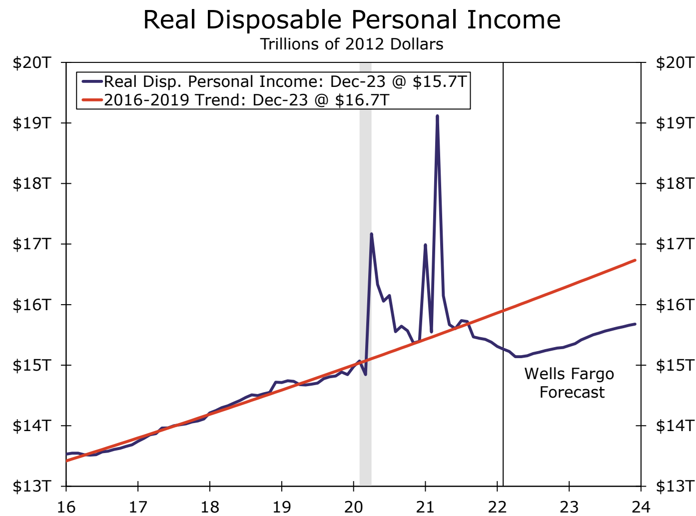
Fed policymakers are increasingly putting the price stability goal above all else.

In the opening remarks of the post-FOMC March meeting press conference, Chair Powell stated that "the Committee is determined to take the measures necessary to restore price stability." We believe this is a notable statement for numerous reasons, with perhaps the biggest one being that the use of the word "restore" suggests price stability has been lost. There is perhaps nothing more sacred to modern central bankers than their credibility on price stability, and the shifting tone from key FOMC officials suggests that policymakers are increasingly putting the price stability goal above all else.

The current economic environment may very well call for such an approach, but it is important to understand the implication behind this shift. *The FOMC appears increasingly ready to do whatever it takes to bring inflation closer to its target, even if this means slamming the brakes on economic growth.* Of course, the objective is to avoid such a sharp adjustment. But a much harder landing that leads to a recession could come about in two ways. The FOMC could underestimate the impact on the labor market from its tightening plans as it tries to bring down inflation. Alternatively, if inflation remains stubbornly high for the next few quarters, the FOMC could *intentionally* induce a much sharper economic slowdown than it currently forecasts.

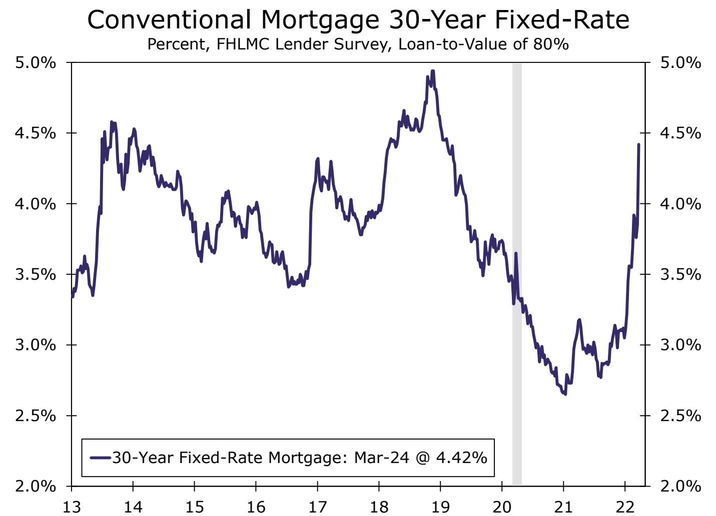
Given the lag with which monetary policy operates and the numerous headwinds facing the U.S. economy, it is not hard to envision a scenario where the FOMC makes a policy mistake. Inflation-adjusted, after-tax personal income has fallen for six straight months from August through January, the latest data available, due to fading fiscal stimulus and elevated inflation. Real household consumption growth has remained decent over this period due to rock-solid household balance sheets, but how long will consumers be willing to swim against this tide? Since January, the inflation outlook has worsened further and fiscal stimulus has faded further into the background. As a result, we expect real incomes to keep sliding in the near term (Figure 7).

Figure 7



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 8



Source: Freddie Mac and Wells Fargo Economics

At the same time, sharply rising interest rates will further crimp real consumption. The exact magnitude of the slowdown from higher interest rates is very uncertain, and therein lies the problem. Job growth could slow even more than we currently forecast as companies respond to weaker aggregate demand, putting additional downward pressure on income growth at a time when incomes are already squeezed. This in turn would lead to weaker aggregate demand and could give rise to the all-too-familiar downward spiral of a recession.

The magnitude of the impact from monetary policy tightening is hardly the only question mark. The timing of when the impact will be felt from higher rates is also uncertain. Financial markets are forward-looking, and as a result monetary policy tightening is already happening despite just one rate hike so far. Since October 1, the two-year Treasury note yield has risen by nearly 200 bps, and the yield on the 10-year Treasury note is up nearly 100 bps. The most recent Freddie Mac survey of mortgage lenders shows that the average 30-year fixed-rate mortgage is 4.4%, up from 3.0% in early October (Figure 8).

Rapid moves to a new equilibrium can be highly disruptive to the economy.

During the past expansion, the FOMC tightened monetary policy slowly, hiking the fed funds rate by 225 bps over a four-year period. This approach allowed Federal Reserve officials to assess the impact of their policies and adjust course accordingly. Today, the current dots imply more than 250 bps of tightening over less than two years paired with a much faster balance sheet runoff policy. The past two years have shown that rapid moves to a new equilibrium can be highly disruptive to the economy. In a world where potential GDP growth is around 2%, underestimating the impact from such rapid tightening could yield an economic swoon.

As if the risks from inflation and interest rates were not enough, COVID continues to quietly lurk in the background. COVID case counts in the United States are down significantly from their January peak, but the same cannot be said for many other countries around the world. Cases have risen in parts of Europe and Asia. Hong Kong in particular is in the middle of a severe COVID wave. The U.S. economy has gotten increasingly adept at dealing with each successive COVID wave, and we do not anticipate any *major* disruptions from rising cases. However, even moderate disruptions could create additional strains on the economy by exacerbating existing inflationary trends.

Furthermore, there is the distinct possibility that a sharp slowdown will be induced *intentionally* rather than *accidentally*. It is not hard to imagine a scenario where core inflation is still running at a 4%-5% annualized pace later this year or early next given elevated inflation expectations, ongoing risks to supply chains and an already very tight labor market. We have already seen how quickly key FOMC officials can change their tune in just a few months, and what seems extreme today can quickly become possible or even likely tomorrow. If core inflation remains stuck at 2-3x the FOMC's target, it seems plausible to us Chair Powell eventually could face a "Volcker moment" whereby the economy needs a hard reset. To be clear, this is not our base case, but the probability of this outcome has become non-zero after several decades of inflation that rarely cracked 2% on a sustained basis. Under

this scenario, we would not be surprised if the Fed simply tightens monetary policy until inflation comes back down to target, full stop.

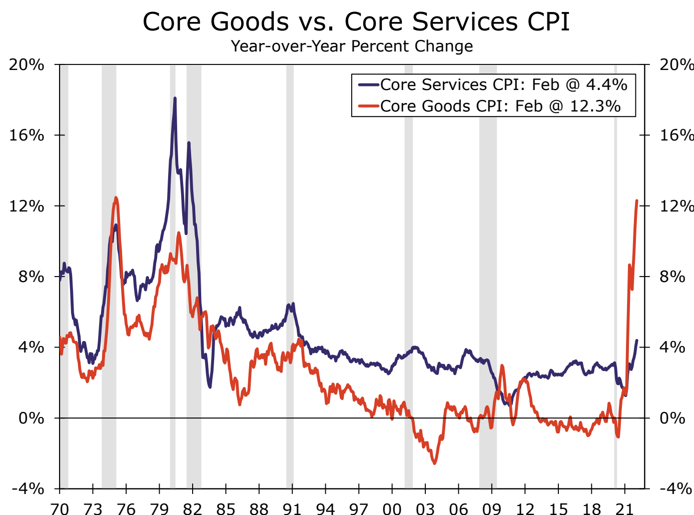
Jay Houdini: A Seemingly Magic Escape from Inflation

How might the Fed be able to thread the needle on economic growth and inflation over the next year or two? Ultimately it will require inflation pressures to be transitory, even if the Fed chooses not to use that term. Inflation falling nearly back to target without growth slipping below potential or unemployment rising in any meaningful way suggests that inflation will be curtailed organically. That will likely require a number of pieces to fall into place.

Inflation falling nearly back to target without growth slipping below potential suggests that inflation will be curtailed organically.

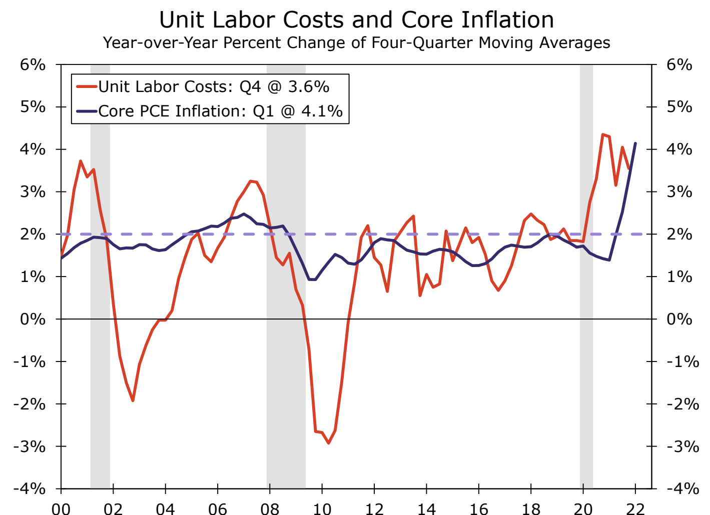
First, consumers would need to show a willingness to tap the "excess savings" built up over the pandemic. That would allow real *spending* to continue to grow even as real *income* stalls under the weight of inflation and absence of fiscal support. Americans have barely put a dent into the $2.36T excess savings accumulated over the pandemic. Even more helpful would be a more pronounced shift in spending toward services and away from goods. Goods still accounted for more than 40% of real consumer spending in January compared to a pre-pandemic peak of 36%. The marked shift in buying patterns that has persisted for nearly two years has contributed to core goods inflation soaring to the highest rate since 1975, while core services inflation has been much less remarkable in a historical sense (Figure 9).

Figure 9



Source: U.S. Department of Labor and Wells Fargo Economics

Figure 10



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Economics

Relief on goods inflation likely will require not only some dampening in goods demand as spending shifts back toward services, but also some improvement on the supply front. That could take the form of increased production of key products like semiconductors and/or increased capacity and efficiency across global transportation networks as firms continue to adjust to the swell of goods spending. Relatedly, a resolution to the conflict in Ukraine could prevent new disruptions to the global supply of products, including key commodities like wheat, corn, oil and natural gas. A quick deescalation of the current crisis could allow Ukrainian farmers to get back to their fields and stave off a wider embargo of energy products, in addition to limiting the costly rerouting of rail, air and sea shipping caused by the conflict.

A more persistent source of inflation is emanating from the tight labor market. Employment costs have grown at the fastest pace in decades as demand for workers has rebounded quicker than the supply of labor. As a result, unit labor costs are running well in excess of rates consistent with 2% inflation (Figure 10). A more robust recovery in labor supply, spurred by deteriorating household finances and health concerns, could limit unit cost pressures while at the same time supporting aggregate income and spending as more individuals take home a paycheck. There are hints of this dynamic already taking shape, with the labor force participation rate rising a full point over the past six months and average hourly earnings growth slowing a touch. However, with unemployment currently

at 3.8% and a swath of exits among retirement-age workers, there are likely limits to how much labor cost growth can slow without a steep drop in demand for workers.

Notably, it would likely take a confluence of these events to help stem the current tide of inflation without driving growth below potential as laid out by the FOMC's most recent Summary of Economic Projections. Without each of these factors unfolding in the Fed's favor, the lift is heavier for each on their own.

Jay Gumby: The Economy Bends but Does Not Break

Economic outcomes exist across a spectrum.

Economic outcomes are too often discussed in absolute terms; either Fed tightening creates a recession or it does not. But in the real world, economic outcomes exist across a spectrum. In our view, the current recession discussions miss an in-between scenario: a significant slowdown in economic activity that takes GDP growth below potential and prevents the labor market from tightening further, but an outright recession is avoided.

The latest Fed projections still paint a relatively rosy outlook, with economic growth never weakening to the point where output growth is below its trend run-rate. However, by definition restrictive monetary policy should lead to subpar growth, i.e., output growing slower than potential, as interest rates above their equilibrium level restrain demand growth. Pushing down economic growth just enough to alleviate pressure on resources but not so much as to tip the economy into a recession is a difficult needle to thread. The eye of the needle looks particularly narrow given the lower run rate of the U.S. economy today and the current state of inflation, hence the concerns about the FOMC's ability to curtail inflation without tipping the economy into a recession.

If growth, and by extension the labor market, are bending to the point of breaking, the Fed itself may bend a bit on its 2% inflation goal.

However, if it looks as if growth, and by extension the labor market, are bending to the point of breaking, the Fed itself may bend a bit on its 2% inflation goal. While inflation is seemingly the one and only priority at present, how the Fed weighs the tradeoffs between above-target inflation, employment and economic growth can shift. If inflation has rolled over but the unemployment rate is moving back up above 4%, which is the FOMC's median longer-run estimate, the Committee may become more comfortable living with inflation moderately above target for a time in order to avoid the devastating effects of a recession. Core PCE inflation of 2-3% may have seemed downright hot in the 2010s, but after the current bout of price growth, it would still mark a vastly improved situation.

Conclusion: Recession Odds Elevated, but Not Inevitable

The U.S. economy is not in immediate danger of entering a recession, in our view. Our preferred model for predicting a recession based on the Leading Economic Index currently estimates just a 1% probability within the next two quarters. That said, the risk of a recession further out looks materially higher, in our view. The U.S. economy is facing numerous headwinds. Real incomes are declining due to inflation and the absence of fiscal support, global supply chains face ongoing risks from COVID and geopolitics, and the highest inflation in 40 years has left the FOMC determined to restore price stability. Given the difficulty in assessing the magnitude of tighter policy on the economy and that the FOMC looks poised to tighten policy quite quickly, it is not hard to see how the Fed may over-correct on inflation and accidently tip the economy into a recession, or even knowingly push the economy into a recession if inflation continues to run in the mid-to-high single digits.

We put the odds of the U.S. economy contracting at some point between now and the end of 2023 at 30%.

The typical state of the U.S. economy is one of growth. Since 1990, the economy has been in recession only 9% of the time. But the challenges of today's environment lead us to believe recession risks are unusually elevated; *we put the odds of the U.S. economy contracting at some point between now and the end of 2023 at 30%.*

Our base case remains that the Fed tightens policy further over the next year or two without generating a recession. Admittedly, the path to economic growth settling nicely back to trend and unemployment being more or less unchanged is narrow and will require a number of dynamics around spending and supply factors unfolding in the Fed's favor. But economic outcomes exist across a spectrum. We see a significant likelihood that a technical recession is avoided, but growth slips below trend and the labor market treads water. That, however, may require living with above-target inflation somewhat longer if the FOMC re-weights its priorities as growth and the labor market look shakier.

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