ECONOMIC OUTLOOK
REGIONS
September 2020

Is FOMC (Still) Aiming At The Wrong Target?

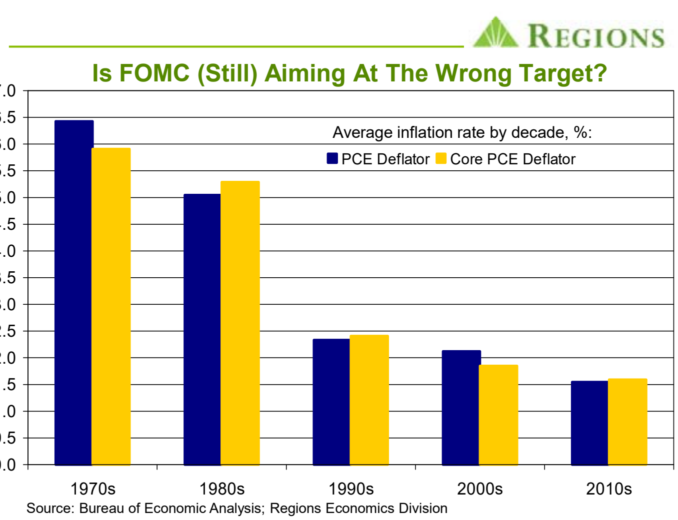
In his address to the Federal Reserve Bank of Kansas City's Economic Policy Symposium, a/k/a the Jackson Hole Conference, on August 27, Federal Reserve Chairman Jerome Powell discussed the FOMC's nearly two-year review of its *Statement on Longer-Run Goals and Monetary Policy Strategy*. As was widely expected, that review resulted in a shift in the FOMC's approach to targeting inflation, moving from a forward-looking symmetric 2.0 percent inflation target to a 2.0 percent average inflation target "over time." Though this may seem like a significant shift, our view is that it changes little, if anything, about the current stance of monetary policy. Moreover, it does not address what we think is a more fundamental matter, i.e., whether an inflation target of 2.0 percent, however measured, is the right target for the FOMC to aim at.

Chairman Powell stressed that the FOMC's new inflation strategy is "flexible," and that it is, as there is no pre-defined period over which an average inflation rate of 2.0 percent is to be achieved, nor is there a pre-defined "look-back" period over which deviations from the desired average inflation rate will be made up for. Their revised policy statement, however, does suggest that the FOMC will actively seek to bring about faster inflation to compensate for periods in which inflation has run below 2.0 percent, noting that "appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time." Or, to borrow a phrase that has been widely used in analyst and media accounts of the new inflation strategy, the FOMC will "allow inflation to run hot" as a means of compensating for periods in which inflation has run below 2.0 percent.

Kind of like how the FOMC has "allowed" inflation to run below its 2.0 percent target since that target was formally adopted back in 2012? Based on the PCE Deflator, the FOMC's preferred gauge of inflation, inflation has averaged 1.4 percent since 2012, while core inflation has averaged 1.6 percent. This is, keep in mind, a period mostly characterized by a Fed funds rate target range of 0.00 to 0.25 percent and an expanding Federal Reserve balance sheet. Yet, we are now to presume that the FOMC can "allow" inflation to run above target by a specific magnitude for a specific length of time and then rein it in at a specific pace, all without causing any disruptions in the financial markets or the broader economy? Sure, there's only one way we're ever going to know if they can actually do so, but we're not exactly in a hurry to find out.

Save for a brief spell in 2018, core PCE inflation has been easily below the 2.0 percent target since the target was adopted in 2012. But, suppose that core inflation had averaged exactly 2.0 percent over this span, and then ask what else, if anything, in the economy would have been different, and to what extent. In other words, are there any material implications for the broader economy from core inflation having averaged 1.6 percent rather than 2.0 percent since 2012? One can also ask why yesterday's rate of inflation should matter when setting today's monetary policy. In effect, the FOMC is saying that it does, without disclosing how many yesterdays it will take into account when making today's policy decisions. To be sure, yesterday's rate of inflation can, and almost surely does, influence expectations of the rate of inflation going forward, but to the extent this is the case, it suggests that inflation expectations, not past rates of inflation, are the appropriate guide for setting monetary policy. If this seems like a distinction without a difference, it is not, as there are always factors other than past inflation that drive inflation expectations.

We do not think this a trivial point, but, even setting this point aside, the notion of any central bank "allowing" inflation to "run hot" assumes a much closer and more well defined relationship between monetary policy and inflation than has been evidenced for quite some time. As we have discussed before, our view is that, for more than two decades now, the main drivers of inflation have been 1) technology; 2) demographics; and 3) globalization. While each of these factors on its own would work to push inflation lower, they have combined to exert a strong downward push on inflation, globally, over the past two-plus decades, as illustrated in the following chart. If an unprecedented degree of global monetary accommodation was a match for the factors cited above, odds are we'd have at least some evidence of that by now.



To those factors we can add a significant degree of slack, in the U.S. economy and the global economy, that will weigh on inflation over coming quarters. Still, the FOMC's revised policy statement notes that "the Committee judges that longer-term inflation expectations that are well anchored at 2 percent foster price stability." Some would argue that in the present environment, the FOMC signaling a greater tolerance for inflation is necessary to

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prevent expectations of deflation from taking hold, though we do not find this argument to be very compelling. Expectations of low and stable inflation are not the same as expectations of deflation, and there was no evidence of the latter even prior to the FOMC's shift in its inflation strategy, nor would there have been any reason for market participants or individuals to have expected deflation.

It is too soon to draw any meaningful conclusions as to whether, or to what extent, the shift in the FOMC's inflation strategy has impacted inflation expectations. Worth watching will be how, in light of the FOMC's shift, inflation expectations and longer-term interest rates respond should economic growth and/or inflation accelerate in the months ahead. While such acceleration would imply a steepening yield curve, would the FOMC respond by stepping up its asset purchases, or even formally adopt "yield curve control"? And, if so, where does it all end? While we may not know where, we have an increasingly nagging sense of how it ends – not well. There are some who argue that the FOMC's shift in its inflation strategy is an implicit admission that the U.S. is burying itself under a mountain of debt, and the only way out is to generate significant inflation. We're not willing to go that far, but nonetheless think the FOMC's shift raises far more questions than it answers. Which is at odds with the notion that monetary policy should be transparent.

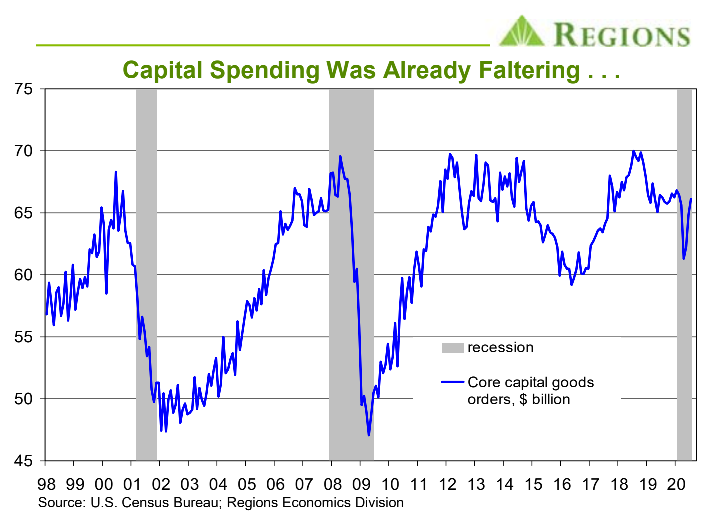
Finally, it is worth noting that the FOMC's revised policy statement contains what, to us, is a striking shift in the language regarding "full employment." Whereas the former policy statement referred to "deviations from" full employment, the new policy statement refers to "shortfalls from" full employment. Put another way, roughly four decades gone from anything resembling a "wage-price spiral," the FOMC seems to have let go of the notion that moving beyond full employment would spark inflation pressures. Aside from any change in their inflation strategy, this alone suggests the FOMC will not be changing the Fed funds rate target range for quite some time.

Give The Wheel A Spin . . .

Over the past several months, economic forecasting has seemingly turned into a game of *Wheel of Fortune*, in which contestants, i.e., forecasters, guess at letters in an attempt to solve a puzzle, i.e., what the economic recovery will look like. "V" was the early popular choice, but "U" and "W" have also been popular picks. As for us, we picked a question mark, for which we were promptly disqualified on the grounds that there are no punctuation marks, however appropriate they may be, on the big wheel.

The further into the recovery we get, our choice of a question mark seems more and more appropriate, and the only thing that seems even remotely certain at this point is that this is no "V-shaped" recovery. That hasn't stopped some from looking, however, as was evident in the wake of the report on durable goods orders for the month of July. Though not typically amongst the most widely covered indicators, durable goods orders are nonetheless a valuable indicator of activity in the manufacturing sector. Like virtually every other economic indicator, durable goods orders declined significantly in March and April, as the broad based shutdowns imposed in response to the COVID-19 virus took their toll on the U.S. economy. Also like virtually every other economic indicator, durable goods orders rebounded sharply in May and rose further in June and July. Unlike many other economic indicators, however, the level of durable goods orders has recaptured almost all of the ground lost in March and April. That they have done so in such short order is the very definition of a V-shaped recovery, right? As with virtually every other question pertaining to the economy, the correct answer to that question is "it depends," which in this case means it depends on how you define "recovery."

One analyst used this chart as the basis for a piece celebrating the "V-shaped" recovery in the manufacturing sector. And, while, yes, the pattern in the chart does indeed look like a "V," even if not a perfectly shaped one, whether or not there has been a recovery, let alone a "V-shaped" recovery, in durable goods manufacturing is an open question. In one sense, using the February 2020 data as the benchmark against which to measure progress is reasonable, as February was the last month in which the economic data were free of the effects of the pandemic. Whether or not being back at the level of activity as of February actually leaves you in a good place, however, is quite another matter.



The above chart illustrates our point. We show core capital goods orders, a subset of durable goods orders, which exhibit the same patterns as total durable goods orders with far less volatility but, either way, the point is the same. In the case of core capital goods orders, as with total durable goods orders, returning to February's level may leave you where you were before the pandemic, but still leaves you far below the top in orders seen in mid-2018. While there was some modest growth in core capital goods orders over the final months of 2019, our January 2020 baseline forecast anticipated business outlays on equipment and machinery would be flat-to-slightly lower in 2020. Indeed, we devoted most of the June *Outlook* to a discussion of capital spending and why we expect it to underperform the broader economy over this recovery.

We won't go back over that ground here, but the orders data help illustrate a point very much worth keeping in mind as you process the incoming economic data, which is that there is a difference between a rebound and a recovery, and the former, no matter how vigorous, can still leave you far from the latter. This will be a particularly useful point to keep in mind on October 29, which is the date on which the BEA will release its initial estimate of Q3 GDP. There will no doubt be a deluge of headlines touting a "record increase" in real GDP, with many analysts, us including, expect annualized real GDP growth of better than 20 percent in Q3. Sure, that would be the fastest quarterly growth rate on record, but it would also leave the level of real GDP roughly five percent below where it was in Q4 2019; as we've noted on several occasions, we don't expect a return to that level until 2H 2022. And, to reiterate a point made above, while the pre-pandemic level of activity in any economic data series is a useful benchmark against which to measure progress in recouping losses stemming from the pandemic and the efforts to stem its spread, that doesn't necessarily leave you in a place you want to be, as illustrated in the data on durable goods orders.

How Long Can "Temporary" Last Before It Isn't Temporary?

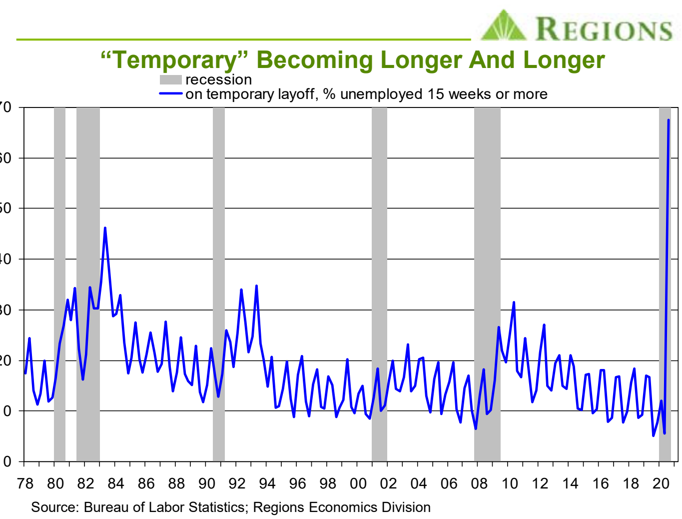
Over the past four months, total nonfarm employment has risen by a total of 10.611 million jobs, while the unemployment rate fell to 8.4 percent in August. While this may seem like a solid start to repairing the tremendous damage done to the labor market by the COVID-19 virus and the efforts to stem its spread – total nonfarm employment fell by a total of 22.160 million jobs over March and April while the unemployment rate hit 14.7 percent in April – the reality is that there is still a long, long way to go before the labor market could be considered fully healed.

There are signs that progress will be harder to come by in the months ahead, and it is possible that the improvement in the labor market won't come in straight lines, i.e., we do not discount the possibility that nonfarm employment could decline and/or the unemployment rate could increase in a given month. One reason to be wary is that, while down considerably from their early-April peak, initial claims for Unemployment Insurance remain notably elevated. The not seasonally adjusted data show over 800,000 filings per week, roughly four times the pre-pandemic run rate, while companies in a host of industry groups have announced job cuts, most of which have yet to show up in the monthly labor market data.

Even aside from these factors, there are elements of the labor market data that suggest that the road to a labor market recovery is getting bumpier and longer. For instance, the duration of unemployment has risen sharply over the past few months, a sign that those who have lost their jobs are either not being recalled to their former job as rapidly as they, or their employer, may have initially anticipated, or are unable to find new jobs. In August, the median duration of unemployment rose to 16.7 weeks, the longest since December 2013 and up from 9.1 weeks in February 2020.

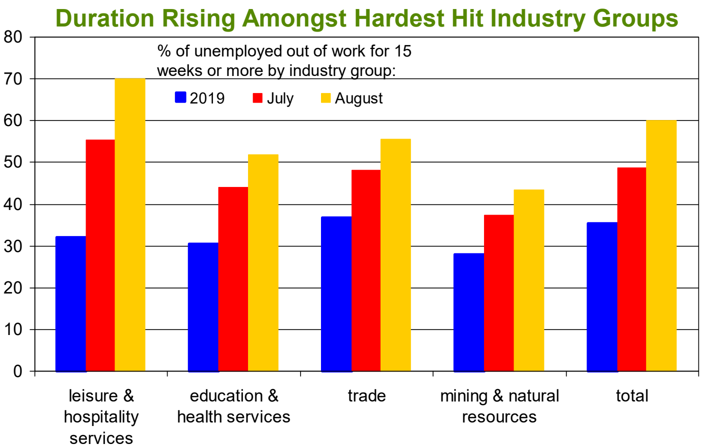
Recall that in April, when nonfarm payrolls fell by 19.385 million jobs and the jobless rate spiked to 14.7 percent, 88 percent of those who lost their job reported being on temporary layoff, as opposed to having lost their job permanently. This was far and away the highest such share in the life of the data, which go back to 1967, but came in the context of wide swaths of economic activity having been shut down as part of an effort to stem the spread of the COVID-19 virus. While the number of those reporting they were on temporary layoff has fallen over the past four months as the economy has reopened, that number nonetheless remains elevated, perhaps more so than many would have anticipated when the restrictions on economic activity were being imposed.

In our analysis of the April employment report, we noted that it would be important to monitor the rate at which those reporting they were on temporary layoff returned to work. Our fear was that a significant number of what began as temporary layoffs would morph into permanent job losses. While it is too soon to draw definitive conclusions, the evidence available at present is not at all encouraging. It should be noted that, historically, in order for one to be considered on temporary layoff, they either had to have been given a specific return-to-work date by their employer or had to expect to return to work within six months. Amidst the pandemic, the BLS relaxed these conditions, allowing the "on temporary layoff" designation to be applied even when there was no certain return-to-work date.



It could be that, with the relaxed reporting guidelines, the number of job losers reported as being on temporary layoff is higher than is actually the case. Still, the duration of unemployment for those on temporary layoff has risen sharply; as of August, 67.1 percent of those on temporary layoff had been unemployed for 15 weeks or more. As seen in the above chart, this is easily the highest share in the life of the data (the data are not seasonally adjusted, hence the considerable volatility). Again, while it is too soon to draw any definitive conclusions, the data suggest our fear of temporary job losses morphing into permanent job losses was not unwarranted.

It is reasonable to assume that the sizable decline in the number of those on temporary layoff over the past few months reflects people having been called back to their jobs as the economy reopened. At the same time, it is more than a bit troubling that in August 6.160 million people were classified as being on temporary layoff – as of February, there were 801,000 people on temporary layoff. And, it could be that part of the decline in the number of those on temporary layoff reflects job losses having become permanent, as the number of permanent job losers rose to 3.411 million in August. The rising duration of unemployment for those on temporary layoff suggests an increased likelihood of longer-term unemployment in the months ahead which ultimately could be reflected in a declining labor force participation rate.



Source: Bureau of Labor Statistics; Regions Economics Division

The BLS's data on the characteristics of the unemployed, part of each month's *Current Population Survey*, include details on the industry group in which a person was formerly employed and the duration of unemployment across the different industry groups. The above chart shows the percentage of unemployed who have been out of work for 15 weeks or more for some of the industry groups hit the hardest by the pandemic and the efforts to stem its spread. Of all workers unemployed as of August, 60.1 percent had been out of work for at least 15 weeks, up from 48.8 percent in July, and much higher than the average of 35.5 percent for 2019 as a whole. Amongst those who formerly worked in the leisure and hospitality services group, 69.9 percent of those unemployed in August had been out of work for at least 15 weeks. Note that the broad "trade" industry group represents both wholesale and retail trade, which are not reported separately in this data series. But, it seems likely that amidst the ongoing structural shift in the retail landscape, which was underway well before the pandemic, those formerly employed in retail trade would be experiencing a duration of unemployment greater than that for the broad category.

It is important to note that the rising duration of unemployment is not limited to the few industry groups shown in the above chart, as the incidence of longer-term unemployment has increased markedly in every broad industry group. The rising duration of unemployment is troubling on many grounds, starting with the line between "temporary" and "permanent" job losses becoming more and more blurred with each passing month. We've all heard or read about small businesses, particularly bars and restaurants, having closed for good, accounts which became more frequent in the wake of the spike in COVID-19 cases that began in late-June and persisted into August. Small business closures go beyond bars and restaurants, with data from *Opportunity Insights* indicating the number of small businesses open is down roughly 19 percent from January. This is not, however, strictly a small business issue, a point reiterated by the recent spate of job cut announcements.

That the duration of unemployment continues to rise is a sign that the recovery is slower and more uneven than many may have anticipated at the onset of the pandemic. If the pace of monthly job gains slows considerably over coming months, as we expect will be the case, longer-term unemployment will become a more protracted problem. Numerous studies have shown that, as the duration of unemployment rises, the odds of one finding another job grow longer and longer, while those who had been out of work for longer stretches tend to earn considerably less if they do ultimately land another job. Many of the long-term unemployed ultimately drop out of the labor force altogether, as was the case following the 2007-09 recession. Indeed, it wasn't until January and February of this year that the participation rate amongst the 25-to-54 year-old cohort, i.e., the "prime" working age population, returned to the peak reached prior to the 2007-09 recession.

As evidenced by the August employment, which was a solid report, the labor market is clearly on the mend. At the same time, however, it would be a mistake to point to the better than 10 million jobs added over the past four months or to an 8.4 percent unemployment rate and assume that the labor market is on auto-pilot, making it simply a matter of time before the job losses seen in March and April are recouped. As this discussion hopefully makes clear, it would also be a mistake to simply focus on the split between temporary/permanent job losses presented in the monthly employment reports. Instead, it is important to go beyond that broad distinction and focus on the duration of unemployment, particularly for those reporting to be on temporary layoff. The longer that duration becomes, the greater the likelihood of lasting damage, both to the individuals who have lost jobs and to the broader economy.

This also plays into the ongoing debate over whether there is a need for Congress to pass legislation providing further assistance for the unemployed. With the Economic Impact Payments and supplemental Unemployment Insurance (UI) benefits of $600 per week provided by the CARES Act having run their course, some are pointing to the recent monthly job growth and the declining jobless rate as evidence that no further aid is warranted. The data on the duration of unemployment suggest otherwise. Keep in mind that those who were amongst the first to lose jobs and file for UI benefits at the onset of the pandemic are now beginning to exhaust their regular state level benefits. True, many are rolling into special pandemic-related programs and will collect benefits for an additional number of weeks, but benefits collected under these programs are not included in the regular claims data. This is relevant because at least part of the decline in continuing UI claims over recent weeks reflects people having exhausted their regular benefits as opposed to having found a job or having been recalled to their former job. The rising duration of unemployment suggests the ranks of this group will continue to grow in the months ahead.

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Q1 '20 (a)	Q2 '20 (p)	Q3 '20 (f)	Q4 '20 (f)	Q1 '21 (f)	Q2 '21 (f)	Q3 '21 (f)	Q4 '21 (f)		2018 (a)	2019 (a)	2020 (f)	2021 (f)	2022 (f)
-5.0	-31.7	25.2	8.5	1.4	1.9	2.1	2.1	Real GDP[1]	3.0	2.2	-4.1	3.1	2.1
-6.9	-34.1	31.9	9.4	0.0	2.6	2.4	2.7	Real Personal Consumption[1]	2.7	2.4	-4.5	3.5	2.4
-6.7	-26.0	0.8	3.8	5.4	4.6	4.9	4.1	Real Business Fixed Investment[1]	6.9	2.9	-6.6	1.9	3.5
-15.2	-35.9	15.2	7.7	3.5	2.3	2.4	2.0	Equipment[1]	8.0	2.1	-10.4	2.0	1.8
2.4	-7.7	0.0	1.7	6.1	6.4	6.7	6.0	Intellectual Property and Software[1]	7.8	6.4	0.9	3.7	5.1
-3.7	-33.4	-25.0	-1.0	8.9	6.7	7.4	5.1	Structures[1]	3.7	-0.6	-11.7	-2.0	4.3
19.0	-37.9	48.0	12.0	5.0	2.6	2.8	0.4	Real Residential Fixed Investment[1]	-0.6	-1.7	2.7	6.2	0.8
1.3	2.8	4.7	-3.2	-1.9	-0.8	-0.4	1.0	Real Government Expenditures[1]	1.8	2.3	2.2	-0.5	0.3
-788.0	-760.9	-868.2	-931.5	-936.5	-936.1	-954.6	-965.9	Real Net Exports[2]	-877.7	-917.6	-837.2	-948.3	-964.1
968	759	945	966	981	996	1,009	1,019	Single Family Housing Starts, ths. of units[3]	872	893	910	1,002	1,040
517	305	445	407	394	393	389	383	Multi-Family Housing Starts, ths. of units[3]	376	403	418	390	378
15.0	11.3	14.9	15.4	15.6	15.8	16.0	16.0	Vehicle Sales, millions of units[3]	17.2	17.0	14.2	15.9	16.2
3.8	13.0	9.0	8.4	8.1	7.7	7.4	7.0	Unemployment Rate, %[4]	3.9	3.7	8.6	7.6	6.5
1.2	-11.2	-6.9	-6.1	-5.4	8.1	3.4	2.6	Non-Farm Employment[5]	1.6	1.4	-5.8	2.0	1.8
2.6	47.0	-17.9	12.0	-26.0	-0.5	-0.8	0.8	Real Disposable Personal Income[1]	3.6	2.2	6.9	-5.5	1.0
1.8	0.5	1.1	0.8	0.8	1.8	1.3	1.6	GDP Price Deflator[5]	2.4	1.8	1.1	1.4	1.5
1.7	0.6	1.3	0.9	1.1	2.0	1.5	1.9	PCE Deflator[5]	2.1	1.5	1.1	1.6	1.7
2.1	0.4	1.1	1.0	1.2	2.6	1.9	1.9	Consumer Price Index[5]	2.4	1.8	1.2	1.9	1.8
1.8	1.0	1.3	1.2	1.2	1.9	1.6	1.8	Core PCE Deflator[5]	2.0	1.7	1.3	1.6	1.8
2.2	1.3	1.6	1.7	1.7	2.6	2.2	2.1	Core Consumer Price Index[5]	2.1	2.2	1.7	2.1	2.1
1.30	0.13	0.13	0.13	0.13	0.13	0.13	0.13	Fed Funds Target Rate Range Mid-Point, %[4]	1.78	2.16	0.42	0.13	0.13
1.38	0.69	0.65	0.78	0.83	0.93	1.06	1.18	10-Year Treasury Note Yield, %[4]	2.91	2.14	0.87	1.00	1.34
3.52	3.24	2.96	2.99	3.01	3.07	3.19	3.29	30-Year Fixed Mortgage, %[4]	4.54	3.94	3.18	3.14	3.37
-1.9	-2.1	-1.9	-1.8	-1.7	-1.9	-2.0	-2.0	Current Account, % of GDP	-2.2	-2.2	-1.9	-1.9	-2.1

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2012 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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