ECONOMIC OUTLOOK

REGIONS

August 2022

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Hopeful Signs, But Still A Long Way To Go On The Inflation Front

When inflation as measured by the Consumer Price Index (CPI) hit 8.5 percent in March, we noted that we thought that would mark the peak rate of inflation for this cycle. At the same time, however, we cautioned against taking a false sense of comfort from that, as "past the peak" and "low inflation" were a long way apart, and noted that saying the worst of inflation was behind us didn't mean things would get better, it just meant they'd get worse at a slower rate – prices would still be rising, they'd just be rising at a slower rate. As it turned out, we were wrong on the "peak" part of that; after slowing to 8.2 percent in April, CPI inflation accelerated to 8.6 percent in May and then 9.1 percent in June, the highest rate of CPI inflation since November 1981. Though not to the same degree, inflation as measured by the PCE Deflator, the FOMC's preferred gauge of inflation, has exhibited similar patterns. PCE inflation hit 6.6 percent in March then slowed to 6.3 percent in April before reversing course and rising to 6.3 percent in May and 6.8 percent in June, the fastest PCE inflation since January 1982.

As to the second part of our call, a number of recent developments have raised hopes that inflation may prove to be less persistent than has been expected, if not feared. Most notably, since peaking at $5.11 per gallon during the week of June 13, retail gasoline prices have fallen by 15.7 percent, hitting $4.30 per gallon during the week of August 1, based on data from the Energy Information Administration (EIA). To be sure, this still leaves retail gasoline prices up by better than thirty percent year-on-year, but in terms of how gasoline prices enter into the price indexes, the sequential changes are what matters. To that point, on a monthly average basis retail gasoline prices declined by over seven percent in July which, after seasonal adjustment, will knock between three and four-tenths of a point off the July change in the headline CPI.

Lower gasoline prices are not the only factor leading some to hope that inflation will slow more sharply in the months ahead. Recent weeks have seen declines in prices of agricultural and industrial commodities while crude oil prices have also slipped. At the same time, the rate at which prices of imported goods are rising has slowed sharply while prices of core imported goods and non-auto consumer goods have been falling. The prices paid component of the ISM Manufacturing Index fell sharply in July. While the ISM's gauge shows prices of non-labor inputs are still rising, they are doing so at a slower rate while increases in input prices have become less broad based, with the share of firms reporting paying higher input prices slipping to a two-year low. In addition to falling energy and commodity prices and price pressures on non-labor input prices easing, shipping costs have also been falling. It would figure that, at some point, these developments would be reflected in measures of inflation on the wholesale and retail levels, setting the stage for a quicker retreat in inflation which would be taken into account by the FOMC as they deliberate the path of the Fed funds rate in the months ahead.

We remain somewhat skeptical, however, and continue to expect inflation's retreat to be anything but hasty. For instance, even if the CPI rose by only 0.3 percent in July, as we expect given the impact of lower gasoline prices, that would still leave it up 8.8 percent year-on-year. Sure, it's less than the 9.1 percent increase in June, but that doesn't feel like all that much progress. Moreover, while energy and commodity prices have been falling over recent weeks, that is much more a reflection of weaker demand than of improved supply. Indeed, U.S. refiners who had been running at basically full capacity cut back on runs in what is typically the peak summer driving season. We continue to see supply/demand balances in energy and commodity markets as somewhat tenuous, leaving the economy vulnerable to supply-side shocks that could trigger a new round of price increases. And, if we are correct on this point, it puts a floor under prices, unless of course demand takes another leg down as the economy slows.

Even if June marked the peak of headline inflation, that is not likely to be the case with core (i.e., exclusive of food and energy prices) inflation. Our forecast of the July CPI data would translate into core inflation of over six percent, faster than in June, and we could easily see further acceleration of core inflation into the fall. Though inflation as measured by the PCE Deflator tends to run lower than inflation as measured by the CPI (due to differences in how each is constructed and the weights of the individual components), the patterns tend to be very similar, so that no matter how you measure it, core inflation could prove to be more stubborn than headline inflation over the next few months.

Between it being far from certain that inflation will decelerate to a meaningful degree and Federal Reserve Chairman Powell having on several occasions stated that the FOMC will need to see "clear and convincing" evidence that inflation is slowing, the reaction in the financial markets to Chairman Powell's press conference following the July FOMC meeting was all the more curious. Equity prices jumped while yields on U.S. Treasury securities fell sharply, and a prime catalyst seems to have been Chairman Powell stating that "at some point it will be appropriate to slow down" the pace of Fed funds rate hikes. After back-to-back hikes of 75 basis points, we saw this as nothing more than him having stated the obvious. But, between him doing so and noting that the Committee was effectively abandoning forward guidance and becoming more "data dependent," it was as if many market participants took hopeful signs of a peak in headline inflation as setting the stage for a "dovish pivot" in the FOMC's policy stance.

We thought this was a case of market participants getting way ahead of, if not themselves, then the FOMC, and noted that the Committee would likely not be pleased to see financial conditions

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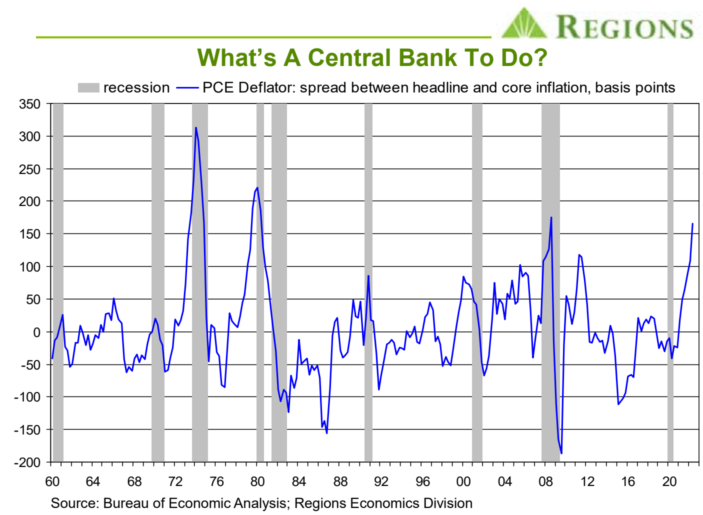
easing in the days following their July meeting. We expected FOMC members to push back on market participants when the "blackout" period around the July FOMC meeting (the period before and after each FOMC meeting during which Committee members make no public comments) ended, and that proved to be the case in the week of August 1. Public comments from San Francisco Fed President Mary Daly, Minneapolis Fed President Neel Kashkari, Cleveland Fed President Loretta Mester, Chicago Fed President Charles Evans, and St. Louis Fed President James Bullard made it clear that the Committee's work is, in the words of Dr. Daly, "nowhere near almost done."

While it was a bit bemusing to see some FOMC members channel their inner Captain Renault, wondering wherever would market participants be getting the notion of a dovish pivot, the "nowhere near almost done" part of the message seems to have taken hold. Yields on U.S. Treasury securities, particularly two-year notes, have rebounded, and at present markets are pricing in a better than even chance of another 75-basis point hike in the Fed funds rate at the September FOMC meeting. Beyond that, it seems reasonable to expect rate hikes to come at a slower pace, but that of course will depend on the evolution of the data, particularly the data on inflation and the labor market. That also leaves how far the FOMC will go very much of an open question.

While it may seem the obvious answer is that the more persistent inflation is, the higher the funds rate will go, that could at some point put the FOMC in an uncomfortable predicament. It is clear the economy has slowed under the weight of elevated inflation and rising interest rates. Further increases in interest rates will lead to further slowing in the economy, but it remains to be seen how much that would buy the FOMC in terms of lower inflation. After all, higher interest rates won't lead to more food, energy, or motor vehicles being produced, nor will they lead to an increase in the supply of labor or facilitate a more growth-friendly regulatory landscape. So, if you can't make the supply side of the economy better, the only way you can stem inflation pressures is to make the demand side of the economy worse, or, to borrow a phrase from Chairman Powell, to "do a job on demand."

It is reasonable to wonder whether, or to what extent, the FOMC will maintain their resolve should they be facing an economy either in or teetering on the verge of recession while inflation remains significantly elevated, particularly should there be marked deterioration in labor market conditions. Many FOMC members have stated that they see a recession as a less costly outcome than allowing inflation to remain unfettered and, in turn, seeing inflation expectations, both near-term and longer-term, move meaningfully higher. That judgment, however, seems predicated on the notion that, should the economy slip into recession, it is likely to be a brief and mild recession. The counter to that, however, is to ask whether a brief and mild recession would be enough to make a noticeable dent in inflation and, if not, would the FOMC be willing to stay the course.

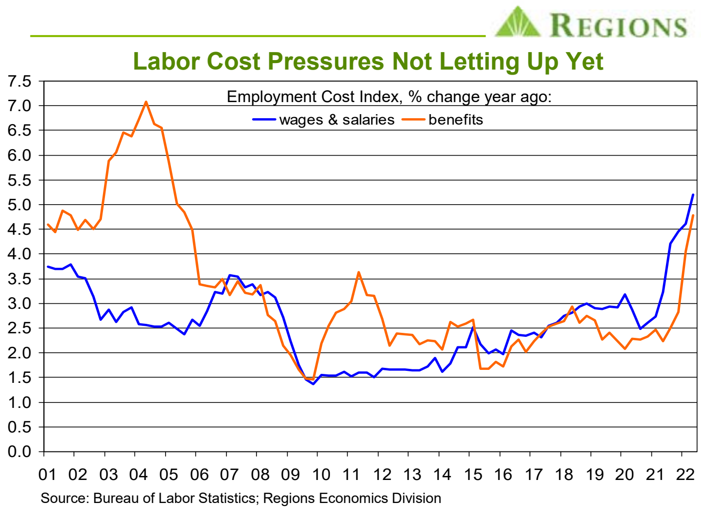
That question would become harder to answer should it be food and energy prices that are sustaining inflation. As noted above, despite recent declines in energy prices and prices of agricultural commodities, we see these markets as remaining vulnerable to adverse supply shocks that could easily trigger a new round of price increases which would, in turn, push headline inflation up. It could be that further deterioration in economic conditions leads to slowing core inflation, particularly if a softening labor market acts as a drag on rent growth, without much relief from headline inflation. It is far from clear how the FOMC would respond to that set of conditions. It is interesting to note that, as illustrated in the following chart, we are at present seeing the widest gap between headline and core inflation since 2008 and the fourth largest such disparity in the life of the data on the PCE Deflator (using data from the CPI would yield the same patterns, but at higher levels).



While core inflation has typically been viewed as a better indicator of underlying trends, inflation expectations, particularly amongst consumers, are formed on the basis of headline inflation, as was noted by Chairman Powell in his press conference following the June FOMC meeting. It has been the case that recessions have typically led to meaningful decelerations in inflation that have seen headline inflation fall below core inflation. But, note that in each of the three instances in which the gap between headline and core inflation has been larger than is the case at present, narrowing those gaps has been attached to deep and prolonged recessions. That isn't to say that would necessarily be the case this time around, particularly in an economy in which nothing has been normal for the past two-plus years. It does, however, raise the possibility that the FOMC stops raising the funds rate while inflation remains well above their 2.0 percent target. Were that to prove to be the case, however, that would leave the FOMC far away from actually cutting the funds rate, even though some are anticipating rate cuts as soon as Q1 2023.

Labor Market Not Doing Its Job, At Least Not Yet

The FOMC's quest to "do a job on demand" as a means of helping rein in inflation includes doing a job on labor demand. The premise being that a pronounced mismatch between labor demand and labor supply has fueled wage pressures which, in turn, are a primary contributor to inflation pressures in the broader economy. One could argue that pushing down total labor input in an already supply constrained economy is hardly the best way to go about bringing down inflation, and one could also note that the empirical evidence on a causal relationship between wage growth and inflation is hardly clear. Be that as it may, for the purposes of this discussion, how the FOMC views these relationships is what matters. So far, however, there is little to suggest that the labor market has softened to any meaningful degree, let alone to a degree sufficient to take the steam out of wage pressures.

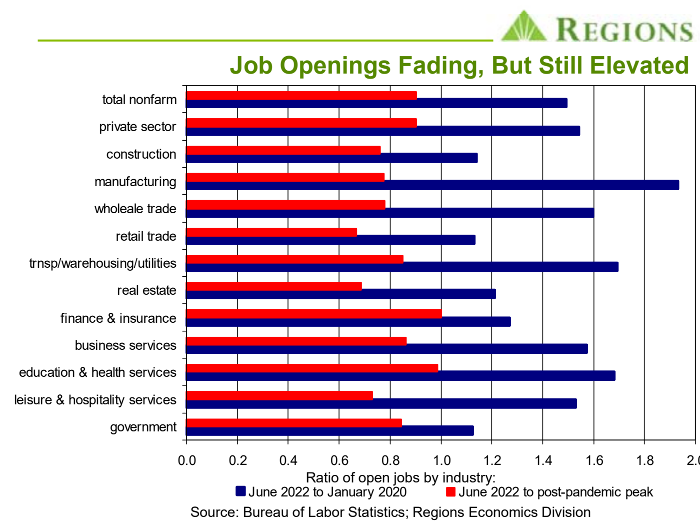


Just two days after the July FOMC meeting, the Bureau of Labor Statistics (BLS) released the Q2 2022 data on the Employment Cost Index (ECI), considered by many, including the FOMC, to be the most reliable indicator of trends in labor compensation costs. The ECI tracks compensation – wages and benefits – for the same jobs over time and, as such, is free of the mix issues that can and often do bias the widely followed average hourly earnings metric found in the monthly employment reports. On a year-on-year basis, the ECI data showed wage costs up 5.2 percent and benefit costs up 4.8 percent in Q2, the fastest growth in benefit costs since 2005. Moreover, wage costs for private sector workers were up 5.7 percent year-on-year and were more broadly based across private sector workers than was the case in Q1. Wage growth has also become much more uniform across the four broad geographic regions than has typically been the case historically.

The sharp acceleration in growth in labor compensation costs over recent quarters reflects the difficulty firms have had in not only finding labor but also in retaining labor, as in many cases workers changing jobs have scored sizable pay increases for doing basically the same job. Data from the monthly Job Openings and Labor Turnover Survey (JOLTS), show both ample opportunity and a high degree of willingness for workers to make such changes. The June JOLTS data, the most recent observation as the JOLTS data lag the employment reports by a month, show 10.698 million open jobs across the U.S. economy, the third straight monthly decline since the record high of 11.855 million open jobs in March but still more than fifty percent above pre-pandemic levels of openings.

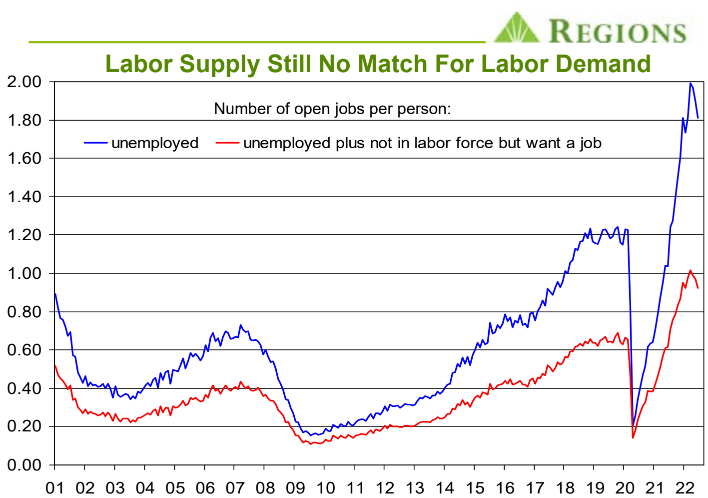
The JOLTS data have gotten considerable attention of late, in part because the FOMC considers the elevated number of job openings as one component of labor demand that is contributing to intense wage pressures. As such, diminishing labor demand can be reflected in fewer open jobs, and a current topic of considerable debate is whether, or to what extent, falling job vacancies can serve as a proxy for job losses as the economy continues to slow. Several FOMC members have argued that they can, which would mean fewer layoffs and a smaller increase in the unemployment rate in either a slowing economy or in a recession than would otherwise be the case. While we agree with this view, at least up to a point, there are many analysts who do not and who argue that it will take a much larger increase in the unemployment rate to alleviate wage pressures, and in turn broader inflation pressures, than the FOMC anticipates will be the case.

Some have pointed to the three straight monthly declines in the number of open jobs as a sign that labor demand is cooling, but a look at the details of the JOLTS data cautions against interpreting declining openings too broadly. For instance, while the number of job openings fell by 605,000 in June, construction and retail trade accounted for over two-thirds of that decline. Retailers have been caught out by unwanted inventory accumulation amid shifting patterns in consumer spending and demand for consumer durable goods having largely been sated, while construction is clearly sagging under the weight of higher mortgage interest rates. To be sure, should the slowdown in the economy become more broadly based, job vacancies will decline to a greater degree across a wider range of industry groups, but so far there is scant evidence of that.



Another way to put the recent run of declines in job openings in context (what, again with the context?) is to compare the current number of vacancies to the number prior to the pandemic. In the chart above we compare, industry by industry, the level of job openings as of June to the level as of January 2020 (blue bar) as well as to the peak number of openings since the onset of the pandemic (red bar). With the exception of finance, where the peak came in June, openings are lower compared to the peak number since the onset of the pandemic, but this is where it helps to recall that job openings can fall due to a firm pulling an open position or due to a firm filling an open position. While the pace of hiring has slowed of late, the rate at which firms are hiring workers (scaled to the level of nonfarm employment) remains easily above pre-pandemic norms in the aggregate, with construction the only industry group in which the hiring rate as of June was lower than it was prior to the onset of the pandemic.

The above chart illustrates a point which we've made several times, which is that even with the number of vacancies having fallen, labor supply is still no match for labor demand. The number of vacancies remains far above pre-pandemic levels, which at the time were at a record high, and the higher current level of vacancies comes in a labor market in which the participation rate is well below where it was prior to the pandemic. The chart below is another way to illustrate this point. Though the number of job openings fell further in June, there were nonetheless 1.8 open jobs for each unemployed person, and if we expand the pool of potential workers to include those who are not in the labor force but currently want a job (who are not included in the measured unemployment rate), there were 0.9 open jobs for each person in this pool. While both measures are down from recent peaks, they are far above pre-pandemic norms.



Source: Bureau of Labor Statistics; Regions Economics Division

To the extent declining vacancies can be a proxy for layoffs in terms of lowering overall labor demand, there is a long, long way to go before demand has fallen to a degree that would result in a meaningful easing of wage pressures. To be sure, factors such as skills mismatches and mobility constraints make it more difficult to fill positions and cannot be remedied by higher wages, but even allowing for such factors, the labor market remains far from being balanced, as evidenced by the ECI showing the fastest rate of private sector wage growth in the life of the current series.

Moreover, workers continue to voluntarily leave jobs at a near-record rate, which can reflect either workers leaving the labor force permanently via retirement or workers changing jobs. In the JOLTS data, retirements are captured in the "other separations" metric, and the total number of other separations has been fairly stable for some time. The number of quits, while off the record high seen in late-2021, remains significantly elevated and well above pre-pandemic norms. This suggests workers continue to feel quite confident in their ability to land another job, and switching jobs typically yields much larger increases in total compensation than can be secured by staying in one's current job.

Even in a slowing economy, the demand for labor remains notably strong. To the extent that the demand for labor slows in the months ahead, we think that will be reflected in a sequence of developments – a further, substantial decline in vacancies, diminished hours worked, and then rising layoffs. Given how difficult, and how costly, it has been for them to find and retain labor, we think firms would be quite hesitant to resort to layoffs, at least in large numbers. If we are correct on this point, wage pressures may prove to be more persistent than many are expecting. We have for some time argued that wage growth will slow but will nonetheless settle into a trend rate easily above that which prevailed prior to the pandemic. We've seen nothing thus far that would make us change that call.

July Employment Report

July job growth blew expectations out of the water, with total nonfarm employment rising by 528,000 jobs and a modest net upward revision to prior estimates of job growth in May and June. Hiring remained notably broad based across private sector industry groups in July. The unemployment rate fell to 3.5 percent, but this is in part a reflection of a decline in the labor force participation rate. We don't make much of that decline, as it was concentrated amongst those aged 24 and below while participation amongst the "prime working age" cohort (i.e., those 25-to-54 years old) ticked higher. Between the upward revisions for May and June and the gain seen in July, the level of nonfarm employment has surpassed its pre-recession peak, though in leisure and hospitality services and government, payrolls remain far, far below that prior peak.

One seemingly minor detail in the July data that is anything but is the upward revision to average weekly hours worked in both May and June. Between this and the upward revision to job growth, aggregate private sector wage and salary earnings, far and away the largest single component of personal income, are now shown to have grown at an annualized rate of 8.1 percent in Q2 compared to the prior estimate of 7.1 percent, which suggests a revision to Q2 personal income growth in the pending revisions to the Q2 GDP data. Aggregate private sector wage and salary earnings rose by 0.8 percent in July, leaving them up 9.6 percent year-on-year.

It should be noted that July job growth was flattered by seasonal adjustment, and while the household survey data were also impacted by seasonal adjustment noise, that was pretty much of a wash in terms of the effect on the unemployment rate. That said, job growth was still stronger than anticipated in July, but we'd caution against drawing any conclusions from this. For instance, while hiring amongst service providing firms, including those in the leisure and hospitality services industry group, was strong in July, that is consistent with recent patterns in consumer spending. We and many others expect services spending to slow meaningfully after the summer months, which would be reflected in a sharply slower pace of job growth in the services sector. At the same time, the increase in construction employment in July was somewhat puzzling given the ongoing weakness in commercial construction and the recent weakening in residential construction, not to mention the sharp decline in job openings in construction in June. As such, construction employment could easily reverse course in the months ahead.

Even if the pace of job growth does slow as we expect, keep in mind that barring a sustained increase in labor force participation, it would take job gains of less than 75,000 per month to keep the unemployment rate steady. As such, slower job growth may not bring much relief from wage pressures. Between the data on job openings, job growth, and labor force participation, if you're a central banker on a mission to do a job on labor demand, your task must seem more daunting at this point than it did when you embarked on that mission.

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Q1 '22 (a)	Q2 '22 (p)	Q3 '22 (f)	Q4 '22 (f)	Q1 '23 (f)	Q2 '23 (f)	Q3 '23 (f)	Q4 '23 (f)		2019 (a)	2020 (a)	2021 (a)	2022 (f)	2023 (f)
-1.6	-0.9	1.1	0.9	1.1	1.2	1.5	1.6	Real GDP[1]	2.3	-3.4	5.7	1.6	1.0
1.8	1.0	0.7	0.8	1.3	1.1	1.2	1.5	Real Personal Consumption[1]	2.2	-3.8	7.9	2.2	1.1
10.0	-0.1	3.5	3.6	3.3	3.0	3.5	3.4	Real Business Fixed Investment[1]	4.3	-5.3	7.4	4.4	3.2
14.1	-2.7	4.2	2.8	2.3	2.0	2.5	2.1	Equipment[1]	3.3	-8.3	13.1	4.5	2.3
11.2	9.2	6.9	4.7	4.5	4.3	4.4	4.4	Intellectual Property and Software[1]	7.2	2.8	10.0	9.2	5.1
-0.9	-11.7	-8.1	2.4	2.6	2.2	4.0	4.4	Structures[1]	2.0	-12.5	-8.0	-5.6	0.4
0.4	-14.0	-9.7	-3.0	-2.1	0.1	2.1	2.6	Real Residential Fixed Investment[1]	-0.9	6.8	9.2	-5.4	-2.9
-2.9	-1.9	0.8	1.4	1.4	2.3	1.8	1.2	Real Government Expenditures[1]	2.2	2.5	0.5	-1.4	1.3
-1,544.7	-1,474.7	-1,438.9	-1,453.4	-1,475.0	-1,490.6	-1,498.2	-1,508.3	Real Net Exports[2]	-905.3	-942.7	-1,284.3	-1,477.9	-1,493.0
1,187	1,074	996	998	1,001	1,011	1,023	1,037	Single Family Housing Starts, ths. of units[3]	889	1,002	1,131	1,064	1,018
533	577	518	507	500	491	482	476	Multi-Family Housing Starts, ths. of units[3]	402	393	474	534	487
19.1	19.3	15.1	11.3	6.9	2.6	2.4	2.7	CoreLogic House Price Index[5]	3.9	6.2	15.0	16.1	3.6
14.1	13.4	13.7	14.5	14.8	15.1	15.3	15.5	Vehicle Sales, millions of units[3]	17.0	14.5	15.0	13.9	15.2
3.8	3.6	3.4	3.4	3.5	3.6	3.8	3.9	Unemployment Rate, %[4]	3.7	8.1	5.4	3.5	3.7
4.6	4.4	4.0	3.1	2.1	1.4	0.7	0.5	Non-Farm Employment[5]	1.3	-5.8	2.8	4.0	1.2
-7.8	-0.5	-0.1	-1.0	4.8	2.2	2.7	3.1	Real Disposable Personal Income[1]	2.3	6.2	2.3	-5.6	1.9
6.9	7.5	7.5	7.0	6.1	4.6	3.9	3.0	GDP Price Deflator[5]	1.8	1.2	4.1	7.2	4.4
6.3	6.5	6.8	6.8	6.2	5.3	4.3	3.3	PCE Deflator[5]	1.5	1.2	3.9	6.6	4.8
8.0	8.6	8.6	7.9	6.8	5.0	4.0	3.4	Consumer Price Index[5]	1.8	1.2	4.7	8.3	4.8
5.2	4.8	5.4	5.8	5.7	5.4	4.3	3.3	Core PCE Deflator[5]	1.7	1.4	3.3	5.3	4.7
6.3	6.0	6.5	6.6	6.0	5.3	4.2	3.4	Core Consumer Price Index[5]	2.2	1.7	3.6	6.4	4.7
0.17	0.81	2.25	3.34	3.63	3.63	3.63	3.57	Fed Funds Target Rate Range Mid-Point, %[4]	2.16	0.42	0.13	1.64	3.61
1.94	2.93	2.95	3.24	3.26	3.23	3.23	3.25	10-Year Treasury Note Yield, %[4]	2.14	0.89	1.44	2.77	3.24
3.82	5.27	5.42	5.73	5.75	5.69	5.62	5.55	30-Year Fixed Mortgage, %[4]	3.94	3.12	2.96	5.06	5.65
-4.8	-3.8	-3.6	-3.6	-3.5	-3.4	-3.3	-3.3	Current Account, % of GDP	-2.1	-3.0	-3.7	-3.9	-3.4

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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