ECONOMIC OUTLOOK

REGIONS

June 2024

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Okay, 2.0 Percent. Then What?

It seems that hardly a day passes when we don't see one or more persons opining on whether monetary policy is sufficiently restrictive to push inflation back to the FOMC's 2.0 percent target. In a similar vein, another question getting considerable discussion is whether the FOMC can/will begin cutting the Fed funds rate before inflation has returned all the way to their 2.0 percent target. Many days, those engaging in these discussions include one or more FOMC members. Though it is more obvious when the releases pertain to the inflation data, it seems that the reaction to every top-tier data release is couched in these terms. One can make a case that enough market participants viewing each and every data release and each and every public comment made by an FOMC member through this narrow prism has been a prime factor behind what has been considerable volatility in equity prices and yields on fixed-income securities.

Something that almost always goes overlooked, however, is that, as targets go, this particular one has proven to be rather, let's say, elusive. For now, leave aside the questions of whether 2.0 percent is an appropriate inflation target and whether the FOMC, or any central bank for that matter, can actually manage a large and dynamic economy with the degree of precision required to achieve any inflation target, 2.0 percent or otherwise. This isn't to say that these are not valid questions, because they clearly are. They are also questions that don't get nearly as much discussion or debate as they merit. It's just that, at least for now, we'd rather focus on a different question.

Recall that the FOMC formally adopted a 2.0 percent inflation target in 2012, but for years prior to that it was widely assumed that the FOMC was implicitly targeting an inflation rate of 2.0 percent. At the risk of saying the quiet part out loud, we think it's fair to ask whether the extent to which many analysts and market participants focus on inflation "returning" to the FOMC's 2.0 percent target is the financial and economic equivalent of missing the forest for the trees. We think it also fair to ask whether central banks have undue confidence in their ability to not only steer inflation to a preset target but to also keep it there for any length of time. Sure, to be fair, no central bank attempts to target a specific rate of inflation at every point in time, but instead most central banks think of their inflation target as something to achieve on average over a given period of time. That is the approach the FOMC has formally adopted, though without specifying just how long a given period of time is.

The reality, however, is that in over fifty years of data, using the PCE Deflator as the basis of measurement as that is the gauge the FOMC puts the most emphasis on, there are relatively few instances of either headline or core inflation being at 2.0 percent in a given month and there are even fewer extended periods over which inflation has averaged 2.0 percent. Since the FOMC formally adopted a 2.0 percent inflation target in January 2012, headline inflation has averaged 2.2 percent and core inflation has averaged 2.3 percent, as measured by the PCE deflator. One could say that is close enough to deem the FOMC's inflation targeting a success. That, however, would ignore the reality that in the years prior to the pandemic inflation was below the 2.0 percent target almost the entire time – headline PCE inflation averaged 1.4 percent between January 2012 and December 2019 – and that inflation has been above that target since March 2021, including rising to a four-decade high in mid-2022. Not likely what the FOMC had in mind when they formally adopted a 2.0 percent inflation target or when they embraced the notion of average inflation targeting. It does, however, beg the question of just how much control over inflation the FOMC, or any central bank, actually has.

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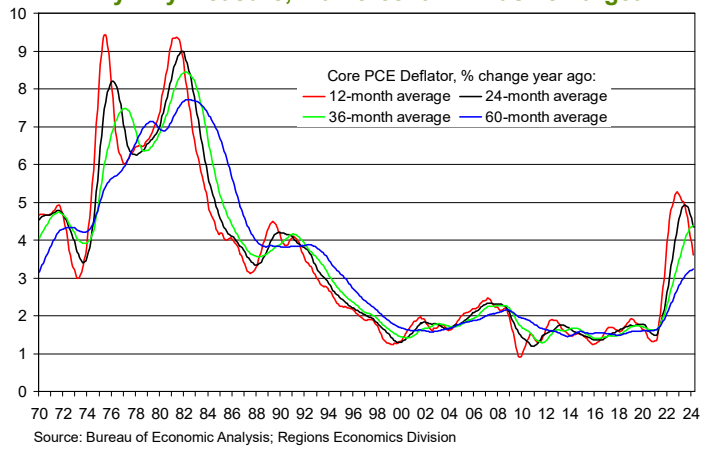
By Any Measure, 2.0 Percent An Elusive Target



Source: Bureau of Economic Analysis; Regions Economics Division

To our earlier point, in case anyone is curious, going back to 1970 there have been twenty-three months (3.5 percent of the time) in which headline PCE inflation has been 2.0 percent, and twenty-nine months (4.5 percent of the time) in which core PCE inflation has been 2.0 percent. Of more relevance, looking at average inflation – in this case core PCE inflation – over longer periods of time shows how elusive an average inflation rate of 2.0 percent has been, as shown in the above chart. The chart helps in understanding that many FOMC members began gravitating around inflation targeting in the mid-1990s, a period in which lower and more stable inflation likely inspired greater confidence amongst central bankers, here and abroad, in the notion that inflation could be guided toward a preset target.

A look at how low, and relatively stable, inflation was between 2012 and the onset of the pandemic may suggest that confidence has been warranted. We have, however, never been on board with that premise. For instance, an often overlooked point is that one reason inflation was persistently below the FOMC's 2.0 percent

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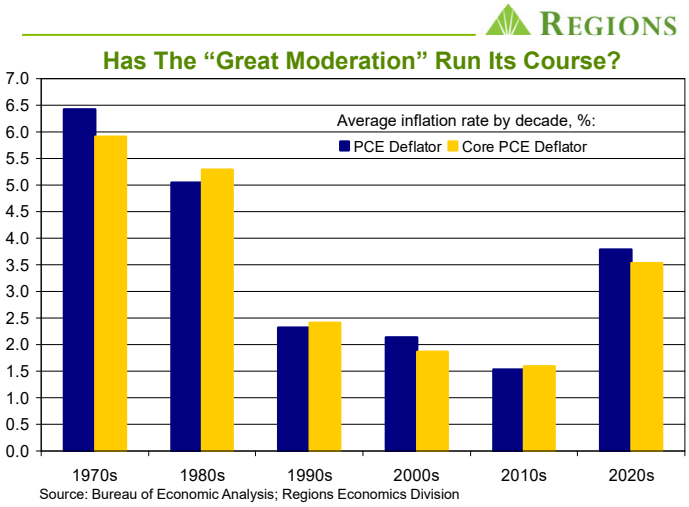
target in the years prior to the pandemic was persistent goods price deflation. Not disinflation, i.e., goods prices rising at a slower rate, but outright deflation, i.e., goods prices falling. Over the 2012-2019 period, the average year-on-year change in the PCE Deflator measure of core goods prices was -0.54 percent, meaning that goods price deflation acted as a persistent drag on overall inflation. Sure, there is something to be said for being in the right place at the right time, but being present when something happens isn't the same as having caused that thing to happen. To be sure, that also applies for the drastic acceleration in inflation after the onset of the pandemic. While one can make a plausible case that monetary policy was too loose for too long, one cannot make a plausible case for that being the sole, or even the main, factor behind the acceleration in inflation in 2021.



This brings us back to a point we've been raising for a number of years. Some argue that the persistent deceleration in inflation that culminated in the low and stable inflation seen in the years prior to the pandemic was the result of better and more credible central banking. While by no means denying that played a role, we've long argued that the prolonged period of decelerating inflation was far more a reflection of three factors – demographics, globalization, and technology. But, as far back as 2018 we began to argue that two of those three factors, i.e., demographics and globalization, were moving in the wrong direction. As such, we argued inflation would likely trend higher over time unless technology/automation led to a pronounced and sustained acceleration in productivity growth sufficient to counter the inflationary impulses of anemic demographics and globalization being in retreat.

Obviously, we did not anticipate a global pandemic and the policy responses, here and abroad, which contributed to the inflation dynamics of the past few years. But, even if the inflation readings in the 2020s have been somewhat distorted, we think that, directionally, the path of inflation depicted above would have held, i.e., inflation beginning to trend higher. That doesn't mean we were arguing that a return to the bad old days of the 1970s or 1980s was likely, we never thought so and still do not think so. We do, however, think the longer-term trend rate of inflation will be easily above that seen in the years prior to the pandemic and, of more relevance here, above the FOMC's 2.0 percent target. To the extent we're right on this point, something that won't be decided for years, that would suggest a different course of monetary policy than would be deemed appropriate by those who believe inflation can, and will, average 2.0 percent over time, even if they're not willing to define the time period over which that would be the case.

Without laying out the terms on which one is doing so, however, the pursuit of a given inflation target may do more harm than good, particularly when that target proves as elusive as the 2.0 percent target has been. Yet, many analysts and market participants continue to couch their analysis in terms of inflation returning to a target that has yet to be hit. This is, at least in our view, a symptom of a broader problem, which is that much of the analysis of the economy and, at least to some extent, decisions on economic policy seem anchored to a more static view of a fixed equilibrium, when in reality the economy does not gravitate toward some well-defined equilibrium in a linear manner. Instead, the economy is dynamic, either expanding or contracting at varying rates, and at any given time there can be, and often are, sectors moving in the opposite direction from the broader economy or moving in the same direction but at a different speeds.

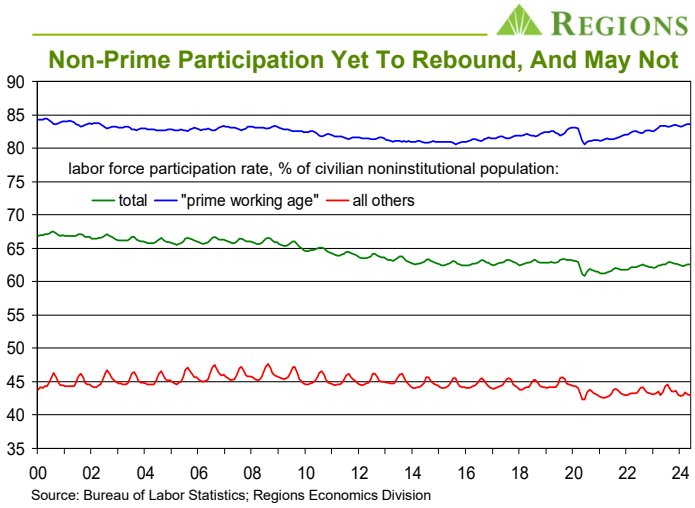
We'd argue that the premise of a fixed inflation target, even if purported to be an average over a given, albeit undefined, period of time, is more consistent with that static view than with the reality of a dynamic economy. Another way to think about it is that over time we see structural shifts in economic fundamentals, yet inflation targets remain fixed at 2.0 percent. One can easily argue that in a dynamic economy any inflation target should either be set as a range or, at the very least, should shift over time to reflect shifts in underlying economic dynamics, as opposed to a one size, or, target, fits all approach. This, however, gets us back to the question of how much influence over inflation any central bank actually has. We'll note that we did find one prolonged period over which inflation averaged 2.0 percent. That would be the period from 2006 through 2010, a period which, oh by the way, included the severe and prolonged 2007-09 recession and a period in which inflation ranged from -1.5 percent to 4.1 percent. Raise your hand if you think that, timing aside, would constitute successful inflation targeting. Seeing no hands, we'll move on to the next topic.

Prime Is Where It's At, At Least In The Labor Force

We and others have for some time been pointing to issues in the BLS's estimates of changes in nonfarm employment and have argued that collection and measurement issues have diminished the reliability of the initial estimates of monthly job growth. A long string of downward, and often sizable, net revisions to the initial estimates of private sector job growth has given credence to this view. There are reasons to think that the BLS's estimates of growth in nonfarm employment thus far in 2024 have been overstated, not the least of which is the latest release of the Q*uarterly Census of Employment and Wages* (QCEW), a comprehensive count of payrolls based on the payroll tax returns which most firms are required to file and which serves as the basis for the BLS's annual benchmark revisions to its estimates of nonfarm employment, hours, and earnings. The QCEW data for Q4 2023 suggest the level of nonfarm employment is lower than has been shown in the monthly employment reports, though this question won't be settled until the benchmark revisions are released early next year.

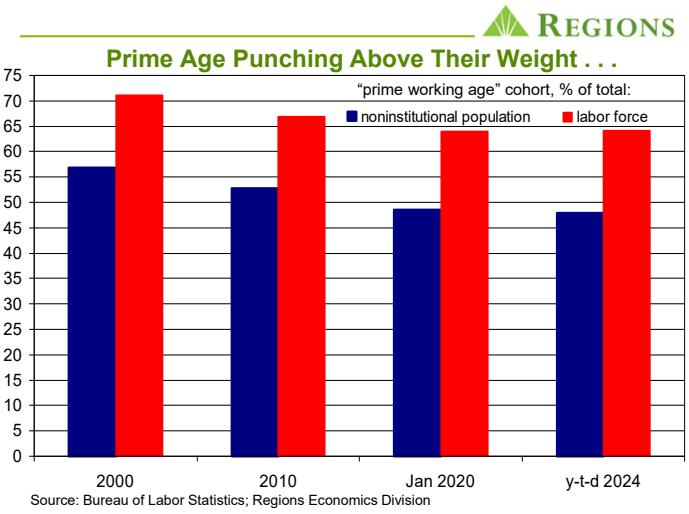
That the measure of employment derived from the BLS's monthly establishment survey is sending a distinctly different signal than the measure of employment derived from the monthly survey of households, from which the unemployment rate is derived, raises even more questions about the actual state of the labor market. Though the two measures are not equivalent – the establishment survey is a count of jobs, the household survey is a count of people – the trends in the two tend to track each other over time. This has not, however, been the case for some time, and the household survey measure shows employment has fallen thus far in 2024.

The household survey data, however, are not without their own flaws. A much smaller sample size compared to the establishment survey contributes to what is typically a high degree of month-to-month volatility in the household survey's measures of the labor force and the level of household employment, and it is clear that the household survey has not captured the wave of immigration apparent in other data series, such as that produced by the Congressional Budget Office. Still, there are those who point to the household survey measure of employment as being a more accurate portrayal of labor market conditions than the measure of employment derived from the establishment survey. In many of these cases, though, they are doing so to reinforce their view of the broader economy, including some who for months have been pointing to the household survey data as evidence to support their contention that the U.S. economy is in recession.



Even if one were to buy the premise that the measure from the household survey is the more accurate count of employment, it isn't clear to us what that would actually be saying about the labor market or the broader economy. We have for some time been highlighting the divergent patterns in labor force participation and employment amongst the different age cohorts broken out in the household survey data, which we illustrate in the chart above. For instance, both participation and employment amongst the 25-to-54 year-old age cohort, often referred to as the "prime working age" population, have more than recovered from the drops seen with the onset of the pandemic. Indeed, the participation rate amongst the prime working age population rose to 83.6 percent in May, and one would have to go back to February 2002 to find a higher participation rate amongst this cohort. In contrast, patterns in participation and employment in the cohorts on either side of the prime age cohort – the 16-to-24 year-old and the 55-and older cohorts – have been notably different. Our estimate, constructed from the household survey data, shows the participation rate amongst the, for lack of a better term, "non-prime" cohort is, at 43.1 percent in May, still below where it was prior to the pandemic, and while employment amongst the non-prime cohort is above pre-pandemic levels, it has nonetheless declined over the past thirteen months. This decline has more than accounted for the decline in total household employment over this same span.

It is, let's say, interesting that we've yet to hear anyone using the household survey measure of employment as the basis for making sweeping conclusions about the state of the labor market or the broader economy make this distinction. Kind of seems like it would matter. In any event, if the labor market were truly crumbling as some claim to be the case, you'd expect to see some signs of that in the data on the prime working age cohort, which far and away accounts for the largest block of both the population measure from which the household survey is drawn and the overall labor force, as seen in the following chart.



Amongst the "non-prime" cohort, it is the 55-and older age cohort that has seen the most pronounced declines in both labor force participation and employment. Participation amongst this cohort fell sharply at the onset of the pandemic and has yet to rebound. Many in this cohort left the labor force at the onset of the pandemic and are unlikely to return, particularly those for whom rising equity prices and robust house price appreciation have bolstered net worth to the point that working is optional. While it may be unlikely that those in this group will return to the labor force, we could see a rebound in participation amongst the 55-and older cohort as more of the prime-age cohort advance in years.

It is the patterns in participation and employment amongst the 16-to-24 year-old cohort that are harder to explain. It is worth noting that labor force participation amongst this cohort fell sharply during the 2007-09 recession and never fully rebounded, which in part reflects more people going to school and staying there longer. Still, the more recent behavior amongst this cohort is somewhat curious, and splitting this group into the two component cohorts, 16-to-19 years old and 20-to-24 years old, doesn't help much. Employment amongst both component cohorts is below pre-

pandemic levels, and while the participation rate amongst the younger cohort is slightly above the pre-pandemic rate, the participation rate amongst those in the 20-to-24 cohort is well below pre-pandemic norms. There is little in the enrollment data that would help account for this, and while recent anecdotal evidence points to a tougher employment environment for this year's class of college graduates, the drop-offs in participation and employment amongst this cohort go back much further. Some have noted that those in this age cohort may be more likely to be engaged in "gig" work and, as such, may not be counted in the BLS's employment data. While that would be true in the case of the establishment survey to the extent payroll taxes are not being collected on gig workers, it would not necessarily be true in the case of the household survey. While this could be part of the answer, keep in mind that the issue of whether, or to what extent, informal workers are adequately accounted for in the BLS's measures of employment pre-dates the pandemic, so the question would be whether the incidence of informal work amongst the 20-to-24 year-old cohort has become more pronounced.

That is another question for another day, but the point here is that, regardless of the reasons, participation and employment amongst the "non-prime" age cohorts continue to lag despite steady increases amongst the prime age cohort. We think this distinction should matter to anyone using the level of household employment as an indicator of labor market conditions. Our view is that while depressed labor force participation amongst the 20-to-24 year-old cohort certainly merits attention, that participation and employment amongst the prime-age cohort continue to push higher is the more telling indicator of labor market conditions.

MayEmployment Report

Total nonfarm employment rose by 272,000 jobs in May, easily outdistancing the consensus forecast of an increase of 180,000 jobs, with private sector payrolls up by 229,000 jobs and public sector payrolls up by 43,000 jobs. Average hourly earnings rose by 0.4 percent in May, leaving them up 4.1 percent year-on-year, up from April's pace. Despite an increase in the unemployment rate, to 4.0 percent from 3.9 percent in April, the May employment report was given the cold shoulder by market participants, many of whom saw the robust job and wage growth as pushing the initial cut in the Fed funds rate further out into the future. That cold shoulder was a stark contrast to the warm embrace received by the April employment report, which showed marked slowdowns in job and wage growth and a higher unemployment rate.

As was the case with the April employment report, our reaction to the May report was a bit different than that of market participants. Just as we did not think the labor market had softened to nearly the degree implied by the April report, neither do we think the labor market to be as robust as implied by the May job and wage growth prints. Indeed, the seeming strength in the May data is, at least in our view, a direct result of the seeming softness in the April data. We spent considerable room in this space last month detailing the issues we saw in the April employment report, and we won't repeat that discussion here. The short version, however, is that we thought the early (i.e., prior to mid-month) end to the April establishment survey period biased the initial estimates of nonfarm employment and earnings lower. We took that into account when producing our forecast of the May data, which helps account for why our forecast that nonfarm payrolls would rise by 258,000 jobs was so far above the consensus forecast.

One way to think about it is that the early end to the April survey period effectively added a week to the May survey period, and that some hiring that actually took place in April would be captured in the May data. By the same token, that the estimate of average hourly earnings in April was biased lower suggested there would be payback in the May data. So, unlike many who pounced on the reported 0.4 percent increase as evidence of wage pressures remaining too intense for the FOMC's comfort, we saw it as no more than evening out the score after an artificially small April increase. For some reason, many seem inclined to treat each new monthly data release as a stand-alone statement of underlying economic conditions but, in reality, a false signal in a given series in a given month will almost always be countered by a false signal in the opposite direction in the following month.

As such, when viewed in concert, the past two employment reports are right in line with other indicators showing cooling labor market conditions. The trend rate of job growth is slowing, as is the trend rate of wage growth, though the far more relevant point here is that growth in aggregate labor earnings continues to easily run ahead of inflation. We know from the *Job Openings and Labor Turnover Survey* (JOLTS) that job vacancies are falling rapidly and the rate at which firms are hiring workers has slipped below the pre-pandemic rate, as has the rate at which workers are voluntarily leaving jobs. Still, it is worth noting that the level of job vacancies remains well above pre-pandemic levels and that the rate at which firms are laying off workers remains below pre-pandemic norms.

All of the above are consistent with the premise of a cooling labor market. We do not, however, attach any significance to the reported increase in the unemployment rate in May. The labor force is reported to have contracted in May while the level of household employment is reported to have fallen by 408,000 persons, neither of which we see as being plausible. Indeed, to our earlier discussion, the decline in household employment was more than entirely accounted for by a decline of 442,000 persons within the 16-to-24 year-old age cohort, and this cohort accounted for almost the entire decline in the labor force. In short, fewer younger adults entered the job market in May than is typically the case for the month, a shortfall that was exaggerated by seasonal adjustment. As noted above, employment amongst the prime-age cohort rose further and the participation rate amongst this cohort rose to a more than two-decade high.

Again, those pointing to the decline in household employment as a sign of marked weakening in labor market conditions either are not aware of the details or do not think they matter. Along those same lines, many point to the increased incidence of part-time employment as a sign of a weakening labor market. As we discussed in our April *Outlook*, however, the vast majority of those working part-time normally work part-time, and that share remains in line with historical norms, which is at odds with the narrative of cash-strapped people having to string part-time jobs together just to make ends meet. The May data show a drop in the number working part-time for economic reasons.

Just as the April employment report did not change our take on the labor market, neither does the May report. We see the labor market as cooling, but nowhere near on the verge of collapse.

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Q4 '23 (a)	Q1 '24 (p)	Q2 '24 (f)	Q3 '24 (f)	Q4 '24 (f)	Q1 '25 (f)	Q2 '25 (f)	Q3 '25 (f)		2021 (a)	2022 (a)	2023 (a)	2024 (f)	2025 (f)
3.4	1.3	2.1	1.9	2.2	2.4	2.3	2.4	Real GDP[1]	5.8	1.9	2.5	2.4	2.3
3.3	2.0	2.4	2.1	2.1	2.0	2.1	2.1	Real Personal Consumption[1]	8.4	2.5	2.2	2.4	2.1
3.7	3.3	1.8	3.1	3.5	3.8	3.8	3.9	Real Business Fixed Investment[1]	5.9	5.2	4.5	3.1	3.5
-1.1	0.3	-0.8	1.8	2.5	3.6	3.9	4.1	Equipment[1]	6.4	5.2	-0.3	0.0	3.0
4.3	7.9	5.9	5.0	4.9	4.8	4.7	4.7	Intellectual Property and Software[1]	10.4	9.1	4.5	5.2	4.9
10.9	0.4	-2.2	1.5	2.4	2.2	1.5	1.8	Structures[1]	-3.2	-2.1	13.2	4.2	1.7
2.8	15.4	0.0	0.7	2.0	2.1	0.9	1.2	Real Residential Fixed Investment[1]	10.7	-9.0	-10.6	5.1	1.3
4.6	1.3	1.6	1.7	1.8	1.8	1.7	1.3	Real Government Expenditures[1]	-0.3	-0.9	4.1	2.7	1.7
-918.5	-975.3	-1,006.2	-1,019.4	-1,016.6	-1,011.0	-1,012.5	-1,010.6	Real Net Exports[2]	-933.8	-1,051.0	-928.1	-1,004.4	-1,012.3
1,060	1,060	1,021	1,011	1,007	1,012	1,010	1,009	Single Family Housing Starts, ths. of units[3]	1,131	1,006	949	1,025	1,010
421	343	353	355	350	343	342	343	Multi-Family Housing Starts, ths. of units[3]	474	546	473	351	343
5.5	5.3	4.6	3.2	2.3	2.2	2.6	3.1	CoreLogic House Price Index[5]	15.4	13.2	3.9	3.8	2.9
15.7	15.3	15.8	15.9	15.9	16.0	16.1	16.2	Vehicle Sales, millions of units[3]	14.9	13.8	15.5	15.7	16.1
3.7	3.8	3.9	4.0	4.1	4.2	4.2	4.2	Unemployment Rate, %[4]	5.4	3.6	3.6	4.0	4.2
1.9	1.8	1.8	1.6	1.5	1.2	1.0	0.9	Non-Farm Employment[5]	2.9	4.3	2.3	1.7	1.0
0.9	1.9	1.6	3.0	2.2	3.3	2.5	2.8	Real Disposable Personal Income[1]	3.2	-5.9	4.1	1.7	2.7
2.6	2.4	2.7	2.4	2.6	2.5	2.4	2.4	GDP Price Deflator[5]	4.6	7.1	3.6	2.5	2.4
2.8	2.5	2.6	2.5	2.7	2.5	2.4	2.5	PCE Deflator[5]	4.2	6.5	3.7	2.6	2.5
3.2	3.2	3.3	2.9	2.9	2.6	2.5	2.6	Consumer Price Index[5]	4.7	8.0	4.1	3.1	2.6
3.2	2.8	2.7	2.9	3.0	2.7	2.5	2.5	Core PCE Deflator[5]	3.6	5.2	4.1	2.9	2.5
4.0	3.8	3.5	3.5	3.4	3.0	2.8	2.7	Core Consumer Price Index[5]	3.6	6.2	4.8	3.6	2.8
5.38	5.38	5.38	5.34	5.09	4.84	4.57	4.34	Fed Funds Target Rate Range Mid-Point, %[4]	0.13	1.73	5.07	5.29	4.45
4.44	4.16	4.47	4.39	4.39	4.38	4.35	4.35	10-Year Treasury Note Yield, %[4]	1.44	2.95	3.96	4.35	4.35
7.30	6.75	7.00	6.89	6.85	6.79	6.69	6.61	30-Year Fixed Mortgage, %[4]	2.96	5.34	6.81	6.87	6.65
-2.8	-3.2	-3.1	-3.1	-3.0	-2.8	-2.9	-2.8	Current Account, % of GDP	-3.5	-3.8	-3.0	-3.1	-2.8

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2017 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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