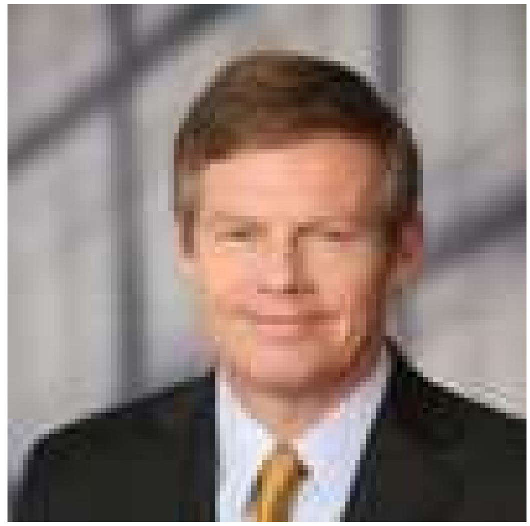

The Recessionary Price of a Faster Decline in Inflation

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In three weeks, I will once again have the honor of running the Boston Marathon as a member of the gasping geezers division of the Dana-Farber Marathon Challenge team. A year ago, as I clambered up the Newton Hills, I resolved that, if I was ever fool enough to do this again, I'd lose a few pounds before attempting it. Admittedly, a few miles later, I made a sterner vow that I would *never* be fool enough to do this again, which made the first resolution seem irrelevant.

However, after a few weeks, the pain eased and I somehow convinced myself to take another shot at the race. And so I set about losing 10 pounds. My one advantage in this endeavor was that I had plenty of time to achieve this goal so I could take it slowly. Being somewhat quantitative in nature, I figured out how many calories I was expending per day and limited myself to consuming roughly 200 calories fewer.

This actually worked out fine since I never felt hungry and, unlike some crash diets, I was sure that I was slowly getting rid of fat rather than muscle. While the marathon still looks daunting, it will be an older but lighter David at the starting line in Hopkinton this year. I would definitely recommend losing weight slowly as the healthiest way to do it.

If only the Federal Reserve would have the same patience with regard to inflation.

It's still a close call as to whether the U.S. economy will fall into recession this year. The recent banking turmoil will likely induce further credit tightening and this, together with the impacts of fiscal drag on consumer spending, falling profits on investment, higher mortgage rates on homebuilding and a high dollar on trade, could well be enough to trigger an economic downturn. On the other hand, the banking turmoil has contributed to lower oil prices, may convince the Federal Reserve to stop tightening soon and could also prod Congress and the Administration into a less-eventful raising of the debt ceiling, all of which could reduce recession risks.

However, while the actual risk of recession is still a close call, the Federal Reserve's latest economic forecasts suggest that they expect one and are at peace with causing one in order to cut inflation faster. But is this a price they, or we, should be willing to pay and what are the investment implications of the choice they seem willing to make?

Fed Forecasts – An Implicit Prediction of Recession

The Fed's implicit recession prediction can be seen in both their growth and unemployment forecasts.

In particular, they currently project that real GDP growth will average only 0.4% in the four quarters ending in the fourth quarter of 2023. As of March 17, the Friday before the latest Fed meeting, the well-known Atlanta Fed GDP tracking model was forecasting 3.2% annualized growth for the first quarter of this year. If Fed officials were factoring that in, or had a similar Q1 forecast themselves, it would imply an average quarterly change in real GDP over the following three quarters of -0.5% and a level of real GDP in the fourth quarter that was 0.4% lower than in the first. Since 1948, there have been no instances of a decline in real GDP over three quarters that was not classified as a recession.

Similarly, knowing that the unemployment rate was 3.6% for February, they forecast that it would rise to a 4.5% average for the fourth quarter. Assuming this also implies 4.5% for November, it would mean a 0.9% increase in the unemployment rate in nine months. Again, there are no records of a nine-month increase in unemployment rate of this magnitude since 1948 that did not occur in a recession.

The Cost of Recession

Implicitly, then, the Federal Reserve appears willing to push the economy into recession in order to achieve a more rapid victory over inflation. But is this accelerated victory worth the price?

Recessions have rightly been regarded as an almost unmitigated evil over the years. While the pain of higher prices is generally felt across all households, the injuries from recession are more concentrated. There are currently 6 million unemployed Americans and even the mild recession envisioned by the Federal Reserve would boost that number to roughly 7.5 million by the fourth quarter. While this would be a very mild increase in joblessness relative to past recessions, it would increase poverty and misery for all those families affected. A recession would also result in the shuttering of many small businesses, leaving many families in financial ruin.

Moreover, it should be stressed that there is no way of telling precisely how high the unemployment rate could rise in a recession once it starts. Recessions tend to feed on themselves, with cutbacks by households leading to cutbacks in business spending and lending. As such, recessions tend to increase economic uncertainty and may, by doing so, impede long-term productivity growth. There may be a Darwinian cleansing effect from the ruthless elimination of inefficient businesses and jobs to free resources for more productive uses, The Austrian economist, Joseph Shumpeter called this process "creative destruction". However, for the most part, recessions are just concentrated misery.

It is also worth noting that recessions fall most heavily on the poor and the less-educated. This is perhaps an obvious point. However, it is still worth noting that, on average, over the past three recessions, while the unemployment rate rose by 3.1 percentage points for those with a 4-year college degree, it climbed by 7.8 percentage points for those who had not completed high school, a group that also has generally far fewer resources to fall back on.

The Cost of Inflation

High inflation is also, of course, an economic evil and, last June, CPI headline inflation vaulted to 8.9% year-over-year, its highest level since December of 1981.

From a coldly macro-economic perspective, the biggest problems associated with high inflation revolve around uncertainty. Businesses find it very difficult to plan for future cost increases or to assess their ability to pass higher costs onto consumers. Lenders demand higher compensation in the form of higher interest rates because the dollars they will be paid back in in the future will be worth less. Moreover, they may well demand further compensation for the uncertainty surrounding future inflation. Higher inflation in one country than in another can also trigger unpredictable swings in exchange rates, impeding international trade.

From a human perspective, high inflation also spreads worry and misery as consumers have a harder time feeding their families and paying the monthly bills, assuming their wages don't quite keep up with the cost of the goods and services they are buying. This has clearly been the case in the most recent bout of high U.S. inflation, since the year-over-year growth of average hourly earnings has now fallen below the increase in CPI inflation for 23 straight months.

However, it should be recognized that much of the uncertainty about inflation has now faded. The year-over-year headline CPI inflation rate has fallen from 8.9% last June to 6.0% in February. We estimate that, even without a recession, headline CPI inflation would fall to 4.0% year-over-year by June, edge up to 4.5% year-over-year by December, fall to roughly 2.5% by the end of 2024 and drift down further in 2025.

While this is not quite the quick return to 2% consumption deflator inflation that the Federal Reserve would prefer, it is hard to see it as an economic emergency. So long as inflation is coming down slowly and predictably, most of the macro-economic ills from inflation become relatively minor.

In addition, it should be noted that any delay in getting to 2% inflation will be due to more stubborn services inflation. A large chunk of this is owners' equivalent rent which is a meaningless concept which should not be in the CPI in the first place.

One other area of stubborn inflation is core services inflation ex housing, a measure which Chairman Powell frequently laments is still slow to come down. He has a point. Even partial compensation for past inflation and tight labor markets can boost wages, particularly for hard-to-find service workers such as hotel workers, restaurant workers, medical workers and teachers.

However, even here wage growth is lagging overall inflation so core services inflation should fade over time. Moreover, it is worth noting that poorer households tend to spend more on goods while richer households spend more on services. Indeed, according to the 2021 Consumer Expenditure Survey, while the top 10% of households in terms of income spent 52% of their income on core services, the bottom 50% devoted only 41% of their spending to this category.

Chairman Powell has repeatedly said that the burden of higher inflation falls most heavily on the poor. However, the burden of higher core services inflation falls mostly on the rich and reducing that inflation by restraining wages and raising unemployment would not be doing the poor any favors.

The Investment Implications of Tougher Choices

All of this analysis may seem somewhat academic in an economy still blessed by low unemployment and financial markets still focused on banking turmoil. However, later this year, if the Fed's projections turn out to be correct, the choice between recession or a slower decline in inflation could become very real. At that point, pressure will likely mount on the Federal Reserve to reverse course and ease monetary conditions. How fast they succumb to this pressure is an open question. However, it is likely that they eventually will do so and because of this, 2024 is likely to be a year of falling inflation and interest rates. For millions of Americans, the cost of the Fed's overly aggressive stance will be very painful. However, for investors, there should be the silver lining of an eventual return to the slow-growth, low-inflation, low-interest-rate environment that did so much to bolster both stock and bond prices in the years before the pandemic.

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