January 2024

# **Fed Thoughts:** Boats Against the Current

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**The test of a first-rate intelligence is the ability to hold two opposing ideas in mind at the same time and still retain the ability to function.**

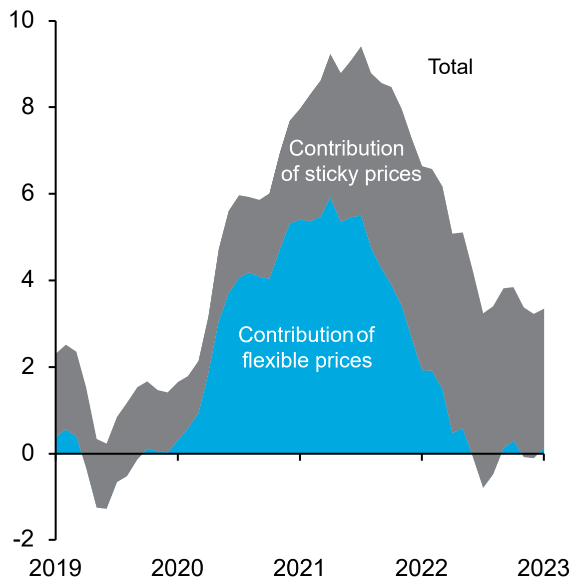
F. Scott Fitzgerald
*The Crack-Up,1936*

We get it. Theory and facts don't always fit together neatly. In 2023, with resources already taut, the US economy grew faster than its underlying trend and inflation fell. Fitzgerald's advice is to live with it. In our case, it means questioning our call that, because the "last mile" in reducing inflation is usually hard, policy easing by the Federal Reserve (Fed) will likely be put off until the second half of this year.

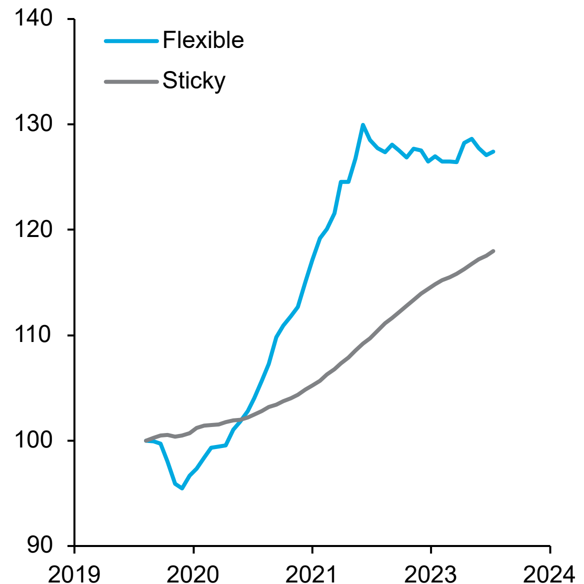
To question, however, is not necessarily to abandon. Two points must be kept in mind about the epigraph.

First, Fitzgerald is counseling about coping, not predicting. The anomalous happens, so get used to it. An anomaly, however, is by definition seldom repeated and the advice about forecasting often offered by Damon Runyon holds: "The race is not to the swift, nor the battle to the strong, but that is the way to bet." Disinflation in 2023 owed to unique circumstances that may not be repeated in 2024. Total consumer price inflation, as represented as the top area of the Consumer Prices and Its Components chart, slowed from its peak because goods with flexible prices, which makes up 30 percent of the basket, cooled.[1]

**Consumer Prices & Its Components**
Twelve-month change, percent




**Flexible & Sticky Consumer Prices**
Levels, 12/2019 = 100




Source: Federal Reserve Bank of Atlanta, firm analysis, accessed 1/15/2024. Note: Flexible prices are the 30 percent of the household consumption basket that are identified as moving frequently. Sticky prices are the 70 percent of the basket that are identified as repricing less frequently. The trend of relative prices is estimated from 1967 to 2020.

- Flexible-price inflation began to slow in July 2022 and turned to deflation within a year, pulling headline inflation down in its wake.

- Goods and services with sticky prices, the other 70 percent of the consumer basket, accelerated at first over that period. Its inflation slowed in 2023, but only about 2 percentage points, to end the year at 4.6 percent over the prior 12 months.

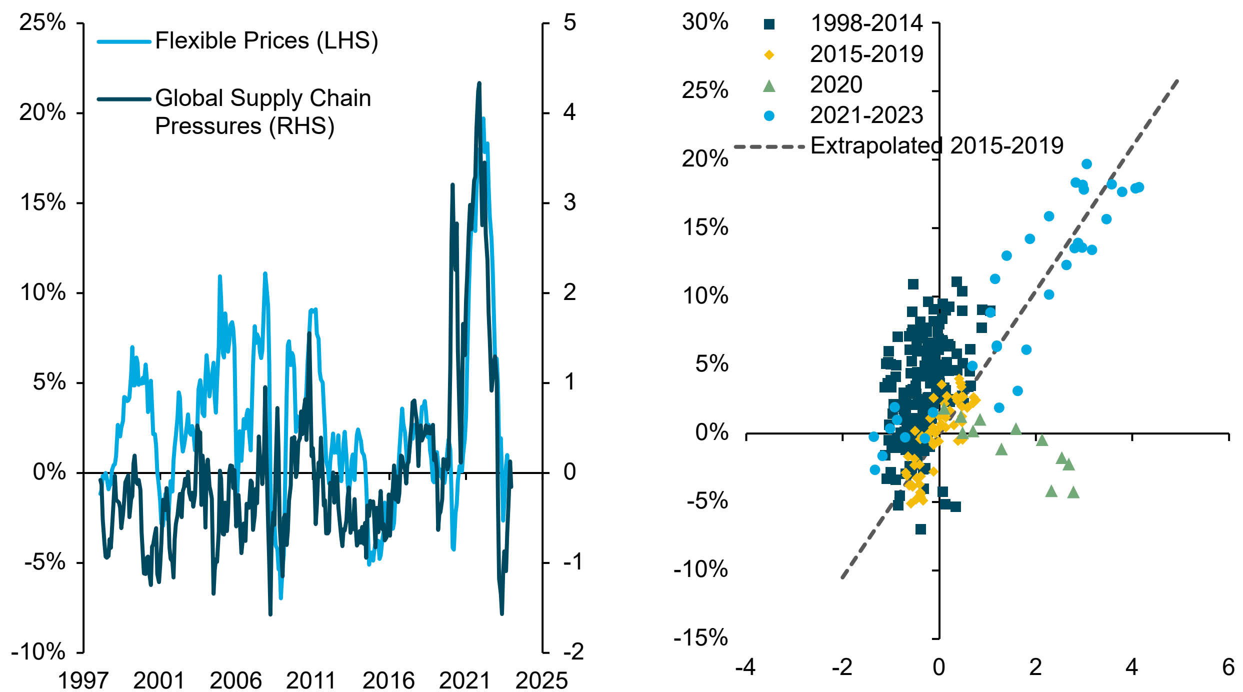
- The difference between the fast- and slow-moving parts of consumer prices implies that the level of flexible prices is about 10 percent higher than sticky prices relative to before the pandemic. That's a large relative price gap that historically is closed by more rapid increases in sticky prices.

We worry that inflation will likely be slow to fall further this year because sticky prices have momentum associated with the need to narrow this differential. Meanwhile, there is ongoing pressure on them coming from an unemployment rate below conventional estimates of its natural level, and the relief from flexible-price disinflation of the past 18 months is unlikely to recur this year.

Why might flexible disinflation not once again offer an easy route to the Fed's goal? The part of the consumer basket that moves flexibly has a high commodity component that is either provided, or a close substitute to goods, from abroad. As such, and as in the chart that follows, those prices move closely with global supply-chain pressures, captured by the dark teal line plotting an index from the Federal Reserve Bank of New York.

**Flexible Prices & Global Supply Chain Pressures**

Flexible prices 12-month change (%), and global supply chain pressures index 3-month average




Source: Flexible prices are the 30 percent of the consumer price index that move freely as identified by the Federal Reserve Bank (FRB) of Atlanta. Global supply chain pressures are an index of shipping from the FRB NY, with zero implying no pressure. From the FRB Atlanta and FRB NY, accessed 1/11/24.

- Indeed, the association between the two has gotten closer over time with the expansion of global trade, excepting the pandemic disruption in 2020. The experience since the pandemic is well described by the close link between the two pre-pandemic, as in the previous scatter plot.

- A further healing of supply chains is unlikely to be repeated this year. Indeed, everything about the fraught global situation, from drone and missile strikes in the Red Sea to low water levels in the Panama Canal, makes it likely supply-chain pressures will be adding to flexible-price inflation.

If sticky prices obey their name and flexible prices add, not subtract, to headline inflation, the Fed will not see a repeat of painless progress in disinflation this year.

Second, Fitzgerald's angst about the anomalous does not give license to mix and match cause and effect, which is why we can't reconcile ourselves with the current pricing of future Fed action. Fed rate guidance currently pencils in ¾ percentage points of nominal cuts this year to keep the policy rate restrictive in real, or inflation-adjusted, terms as economic activity performs moderately well. Such a recalibration of the stance of policy would presumably wait until inflation is demonstrably closer to goal and be served up in dollops of quarter-point cuts.

Markets price in twice as much easing starting early in the year, which is a batten-down-the-hatches policy response usually drawn out of the Fed by pronounced weakening of economic activity. At the same time, buoyant equity prices, narrow risk spreads and subdued forward-looking asset price volatility convey no such concerns about the outlook. That is, investors apparently "…always have a green light that burns all night…," expecting the policy response to distress without distress.[2]

What makes us nervous is that the ongoing self-fulfilling cycle of market confidence in early action intensifies the pressure on the Fed to act early. This undoubtedly threatens our outlook that the Fed doesn't start easing until the second half of the year. Whatever the Fed does, it's hard not to shake the sense that market participants will likely be disappointed this year.

- If we're right about the economy and policy, we believe the Fed will get its soft landing by touching down on the runway a bit later than investors currently hope.

- If we're right about the economy but wrong about the Fed's patience, early easing will likely give way to later concerns as inflation runs hotter than goal, making it unlikely it will be followed by many more cuts.

- If we're wrong and inflation falls immaculately but right that the Fed is slow to move, economic activity will likely weaken more than necessary to restore price stability. However, with inflation close to goal, the problem would be addressable by monetary policy in the second half.

- If we're doubly wrong—about the ease of disinflation and the quickness of cuts—we still don't see how markets can be right about the size of those cuts in an economy performing well.

**Vincent Reinhart**
Chief Economist & Macro Strategist

Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also spent 24 years at the Federal Reserve, holding several roles including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

## Endnotes

[1] This is the decomposition of the data routinely provided by the Federal Reserve Bank of Atlanta, explained and available at https://www.atlantafed.org/research/inflationproject/stickyprice

[2] F. Scott Fitzgerald, The Great Gatsby, New York: C. Scribner's Sons, 1925, p. 92.

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