KPMG Economics

Navigating policy purgatory: Inflation and the challenge for the Fed

The central banker's worst nightmare is to cut rates, then have to raise them.

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The lyrics of The Clash's iconic hit "Should I Stay or Should I Go" have been ruminating in my head. The chorus stands out, "If I go, there will be trouble, and if I stay it will be double."

That is where the Federal Reserve has found itself, stuck in limbo. It has moved back to the sidelines, waiting for inflation to cool, before it moves forward with rate cuts.

Improvements in inflation appear to have stalled or by some measures, reversed. This isn't the first time. A rapid deceleration in inflation in late 2022 appeared to hit a wall in early 2023.

Some of that is due to measurement problems, or what is known as "residual seasonality." The statistical agencies have struggled to adjust data emerging from a pandemic that defied all seasonal norms.

The reality of inflation is probably in between the reports for the fourth and first quarters; that it is still too hot. The Fed's decision to be "cautious" on rate cuts in 2024 now looks prescient.

Fed Chairman Jay Powell was pushed at the press conference following the May Federal Open Market Committee (FOMC) meeting on whether the surge in inflation was worrisome or just a bump, like the Fed expected. He paused for more than 3 seconds, an eternity on live TV, as he weighed his response. He said it was a "signal" that it will "take longer for us to gain confidence" that we are moving to 2% inflation.

This edition of *Economic Compass* takes a closer look at where we are on inflation, how long it is likely to take to cool, and what that suggests about the trajectory for rate cuts. The threshold to cut rates is lower than the threshold to hike, but all options are still on the table. We have reduced our forecast from two to one cut in 2024, in December.

Growth slows but doesn't collapse

Real GDP rose 1.6% in the first quarter, a slowdown from the 3.4% pace of the fourth quarter. Consumer spending on big-ticket durable goods slowed as spending on services remained strong. Residential investment expanded for the third consecutive quarter despite higher rates. Large builders have moved downscale and offered mortgage discounts to tap the pent-up demand among millennials. Business investment slowed while inventories continued to drain. A drop in federal spending due to the continuing resolution was more than offset by spending at the state and local levels.

Real GDP is forecast to rebound at a 2.4% pace in the second quarter, buoyed by an acceleration in consumer spending. Consumers ended the first quarter with gains across all categories. That means consumers don't need to improve a lot on the pace of the first quarter to show an acceleration in spending. Residential investment is expected to eke out another gain buoyed by the single-family market. Inventories are expected to be rebuilt, while a catch-up in federal spending boosts government spending. Business investment is expected to slow in response to the stress of higher rates and the trade deficit is poised to further widen.

The Fed delays. The odds on a September cut moved up after the employment report for April. We left our forecast for a delay to December. One month does not a trend make for the data. The Fed committed to averting the most common mistake central bankers make – cutting too soon. That means a bias to overtighten as the Fed waits for enough data to thoroughly "convince" its leadership that inflation is actually moving closer to 2% than 3%.

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Financial markets rallied at the end of the press conference following the FOMC meeting. They do so at their own peril, as easing financial conditions in late 2023 and early 2024 likely stoked the cooling embers of inflation in the first quarter. Financial markets and the Fed need to move in sync if we hope to derail inflation.

A delay in rate cuts by the Fed could delay cuts by other central banks. The Fed is not the 800-pound gorilla it once was in global financial markets, but its actions still carry a lot of weight. I can't remember a recent FOMC meeting where so many of the inquiries I received from journalists were from abroad: They are not happy with the Fed. (Understatement.)

Inflation

Progress stalled

Chart 1 lays out the dilemma the Fed faces. The core personal consumption expenditures (PCE) index, which excludes food and energy, surged at a 3.7% annualized pace in the first quarter. That is the fastest quarterly acceleration we have seen after rounding in a year.

The jump in inflation was particularly jarring, given the progress that was made during the second half of 2023. The core PCE index dropped to the 2% target, which prompted many to urge the Fed to cut. That would have been premature, an error the Fed is determined to avoid. The worst mistake a central banker can make is to cut, only to have to reverse course and deal with a more pernicious bout of inflation.

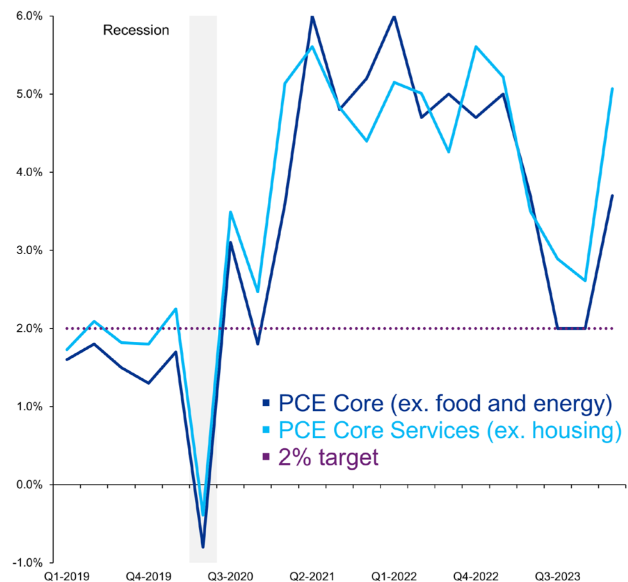
The surge in the first quarter was driven by a jump in services. The super core services PCE, which excludes shelter costs and accounts for half of the core PCE, surged at a 5.1% annual rate. That is nearly double the pace of the fourth quarter. Everything from personal care to legal services and home maintenance costs picked up. The latter includes cleaners, movers and furniture and appliance repairs.

Service sector prices tend to be more sensitive to the cost of labor than goods prices. The employment cost index (ECI), which is the most comprehensive measure of compensation, accelerated at its fastest pace in a year during the first quarter. Those gains were driven by a pickup in compensation in the service sector.

Higher wages are not inflationary as long as productivity growth remains elevated. Unfortunately, productivity growth slowed to a crawl in the first quarter after surging in the second half of 2023. As a result, unit labor costs surged at their fastest pace in a year. Hence, the acceleration in inflation in the first quarter.

Chart 1

Inflation fueled by services
PCE price index, annualized percent change



Source: KPMG Economics, Bureau of Economic Analysis

Easing labor market conditions

Powell is careful not to say the Fed is targeting wage gains. Instead, he and his colleagues have focused on the super core services PCE index. Those prices are not likely to cool until wages slow to a pace more consistent with what we saw pre-pandemic.

The Fed is betting that a drop in job openings and quit rates will eventually cool wage gains. The April employment report reinforced those hopes with a slowdown in the pace of hiring and wages. Wages on job posting sites have come back to 2019 levels, which provides more reassurance. The jury is still out on whether those shifts will cool wages enough to get us back to where we were.

The ECI rose 4.2% from a year ago in the first quarter, which is still nearly one and a half percent above the pace of 2019, when inflation was closer to the Fed's target. This is at the same time the ADP employment report suggested that labor markets may be reheating. The premium for job hoppers widened in March and April for the first time since mid-2022. That could mean the cooling in quit rates we have seen will be short-lived.

The unemployment rate remained below 4% for its 27th consecutive month in April, tying the record last hit during the height of the Vietnam War in the 1960s. That period is looked back upon with caution, as it helped to seed the stagflation of the 1970s. Inflation more than tripled between 1960 and 1969, which made a fertile ground for the stagflation of the 1970s.

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Powell was asked at the May presser whether stagflation was a risk, given the slowdown in real GDP growth in the first quarter. He deadpanned that he had lived it and didn't see "the stag or the flation" now.

Stagflation was a period when inflation and unemployment both rose and stayed there. The consumer price index was stuck at a double-digit pace for 15 straight months between 1974 and 1975; unemployment hit a peak of 9% in 1975 and never came close to hitting the lows of the late 1960s.

A slowdown in shelter costs

Observed rents on both single-family homes and apartments have moderated their pace from earlier in the expansion. The drag those shifts place on measured shelter costs takes time; leases can take a year or more to reset and reprice. The question is whether that is enough?

Observed rents on single-family homes are still growing well above the pace we saw pre-pandemic, while apartment rents have begun to reaccelerate. Millennials are aging into their peak home-buying years – they are now the largest generation of thirty-somethings we have ever seen. They are forming households and want to buy.

When they can't afford to buy, they rent. Absorption rates are even high in some of the most overbuilt apartment markets, while demand for single-family rentals remains extremely elevated.

Moderating goods prices

Last, but by no means least, are goods prices. A drop in goods prices was the largest single factor bringing inflation down in the second half of 2022 and 2023. Much of the initial drop was due to a drop in oil prices. An unusually mild winter, notably in Europe, and a surge in production in the US, held oil prices down.

Moreover, Germany, which was the most dependent on oil from Russia, built floating liquefied natural gas terminals in less than a year. That enabled it to offset the blow to supplies from Russia with an increase in imports from the US.

Separately, a healing of supply chains helped to bring supply into better balance with demand. The swing in the vehicle sector, which suffered the most acute shortages, is one of the most dramatic examples. Dealers went from year-long waits for their most popular models to more than a 70 days' supply in April. That is well above the 60-days' norm pre-pandemic and is triggering recurring rounds of incentives or price cuts.

The problem is that goods prices are no longer decelerating. The core goods measure of PCE, which strips out the impact of energy prices, moved up for the first time since June 2023 in April on a three-month annualized basis. Much of the low hanging fruit from the drop in prices due to a healing of supply chains may have been plucked.

Add escalating geopolitical tensions, a rise in nationalism and a turn inward with nearshoring and friendshoring, a surge in climate-related disruptions and damages, and hot wars and supply chains remain fragile and more susceptible to shocks. The slowdown in traffic traversing the Panama and Suez Canals are two examples – one is due to droughts and low waters, the other due to attacks. Both have boosted shipping costs by as much as 170% in recent months.

This is all in addition to the structural shifts we are seeing in the insurance market. Everything from the move up in the prices of homes and vehicles, to the increases in exposure to climate-related damages, ongoing supply chain problems to labor shortages are boosting the costs of repairs. That is pushing up the price of homeowners' and vehicle insurance. Some places have been cut off from insurance entirely, which places the entire cost of repairs in the hands of owners.

The pandemic catapulted the economy from the slow moving and disinflationary 2010s into the more rapidly shifting and inflation-prone 2020s. Supply chains have healed but remain more vulnerable to shocks in a world where shocks are more the norm. Those shifts will leave the Fed playing defense and force it to more actively keep the lid on inflation going forward. It could also make achieving the 2% inflation target as elusive as we bring inflation down as it was for the Fed to achieve it from beneath in the 2010s.

A hard last mile

Chart 2 shows the forecast for core PCE inflation. The move down from 3.7% is expected to take longer than the move up. Core inflation does not drop below 3% until the summer, which will not fully show up in the economic data until well into the fourth quarter. The forecast doesn't show the core PCE returning to 2% through 2026. Instead, core inflation hovers slightly above the 2% threshold.

There is nothing magical about the 2% inflation target. In the late 1980s, inflation in New Zealand had cooled from a 15% to a 10% pace. When pressed about how low inflation needed to go in a TV interview, the finance minister somewhat arbitrarily replied between zero and 1%.

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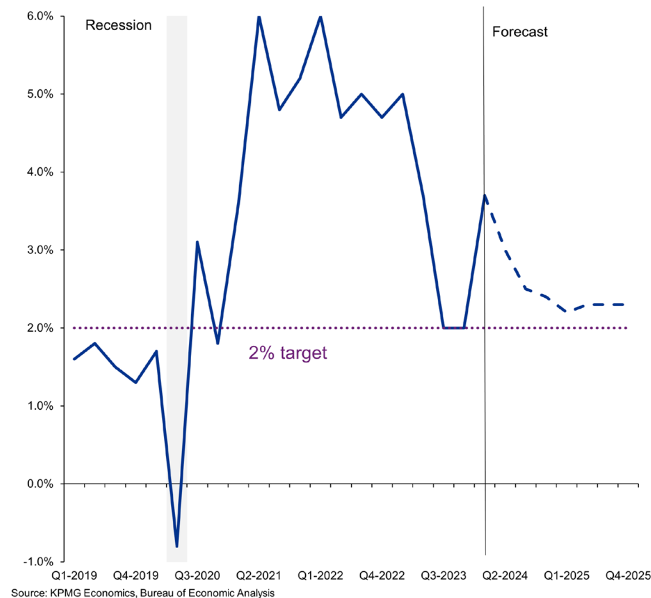
Chart 2



The Reserve Bank of New Zealand was tasked to come up with a concrete target. It added a 1% cushion to account for measurement problems. (The data on inflation tend to be biased upwards.) The result was a 2% target. The Bank of Canada and the Bank of England soon followed suit with a 2% target that was, according to one source, “plucked out of the air.”

The Fed was an outlier due to the dual nature of its mandate to foster price stability and full employment. Former Fed Chairman Alan Greenspan adopted an implicit target of 2% in the mid-1990s for some of the same reasons. The upward bias in the measures of inflation meant a target of zero could cause deflation, which can be harder to escape than a bout of inflation.

The 2% target left more room to cut rates and stimulate when the economy faltered. It enabled people’s views on future inflation to remain anchored, while allowing the Fed some wiggle room to stimulate when economic conditions faltered.

Former Fed Chairman Ben Bernanke did not persuade his colleagues to explicitly embrace 2% until January 2012. That is when the Fed first announced a target for inflation of 2%. The hope was that the 2% inflation target would boost the public’s confidence in the Fed’s ability to warm a chilly economy. The overall and core PCE index never achieved the target for any length of time in the 2010s, due largely to cheap imports.

Now we are on the other side of that coin. Inflation is forecast to cool, but not return for any length of time to the Fed’s 2% target. That doesn’t mean the Fed will officially shift the goal posts on inflation. Rather, it will just keep moving out the timeline it takes to get there. The pain – a Fed euphemism for rising unemployment – needed to get inflation down to 2% may not be worth the last tenths of progress on inflation.

The Fed

A pregnant pause

The Fed feels it has time on its side. Rate hikes take anywhere from 12 to 24 months to work their way through the economy and the last hike by the Fed was in July 2023. The “higher for longer” strategy is designed to allow the stress of higher rates to compound.

The goal is to cool the economy, not send it into a deep freeze. Powell made clear that the Fed no longer sees a recession as the only way to derail inflation, given the extraordinary progress that has already been made on inflation.

When pushed about what would make the Fed cut more aggressively at the press conference following the May FOMC meetings he said an “unexpected weakening in employment.”

Powell dodged a direct question about whether the possibility of a rate hike came up in the May meeting. I would wager it did, given the fact that at least two participants at the meeting raised the issue before we got the final print on the PCE index for March. They didn’t see it as their “baseline,” but couldn’t rule out another hike if inflation proved more stubborn. Another two, who were on the fence for cuts, warned of the possibility of no cuts until 2025.

Powell is more hopeful than his colleagues about the direction of the Fed’s next move but would not hesitate to hike if the recent surge in inflation proved more persistent. The lessons of the 1970s have become institutionalized within the Fed, at least for now.

The worst mistake a central bank can make is to cut only to have to reverse course and raise again. History is littered with examples of when central banks eased to satisfy the whims of politicians and lower unemployment. Any improvements in unemployment were quickly squandered via a further acceleration in inflation. I went into extensive detail in the January 2024 Economic Compass.

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A December cut

Chart 3 lays out the trajectory for the fed funds rate through 2026. The Fed is not likely to have all the data it needs to feel "confident" that inflation is moving closer to its 2% target until well into the fourth quarter. The PCE data for the third quarter will not be out until late October, while confirmation that inflation is still moving down in the fourth quarter will not be available until late November. That puts the first rate cut in December.

What would prompt the Fed to cut sooner? A more rapid deceleration in inflation in the second and third quarters would open the door to a September rate cut, which is why financial markets rallied on the somewhat weaker jobs report. They put a rate cut back into the forecast for September, which is the earliest the Fed could feel confident that inflation is decelerating. A lot would need to break in the Fed's favor between now and then, which is why we left our call for December.

The Fed's own forecasts in March had the unemployment rate rising to 4% by year-end 2024 and 4.1% in 2025. That is not far from our own forecast and close to what the Fed considers "full employment."

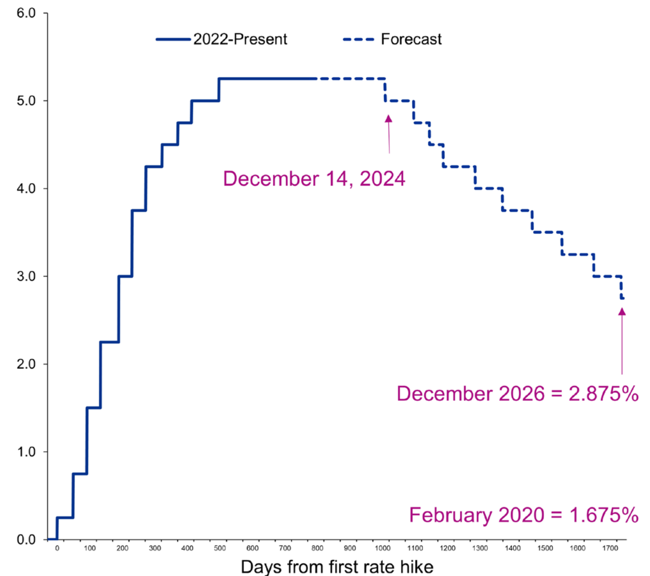
The Fed has raised slightly what it considers its terminal or non-inflationary fed funds rate. It hovered close to 2.5% much of the 2010s but moved closer to 3% post pandemic. A higher terminal rate reflects the increased risk of supply shocks, a move toward more nationalist and protectionist trade policies and the structural threat to inflation posed by climate change.

A terminal target of 2.75%-3% would put the fed funds rate more than one percent above the level hit prior to the pandemic in February 2020. That underscores how much the economy has changed since the 2010s.

A higher rate of productivity growth down the road via adoption of more sophisticated AI models would reinforce that move up in the Fed's neutral fed funds rates. All else equal, economies with faster productivity growth can grow more rapidly, with higher interest rates and no inflation, than those with slowing productivity growth.

What would prompt the Fed to hike? A failure of inflation to improve after the recent run-up. Powell has been careful not to explicitly target wages. The focus on service sector inflation, which is more sensitive to labor costs, is a backdoor way of doing just that. If wages do not cool with the drop in quits and/or get offset by a jump in productivity growth, the Fed will have to put rate hikes back on the table.

Chart 3



Source: KPMG Economics, FOMC

A bias to overtighten. The Fed is what is known as "data dependent," which in and of itself is lagged. The data tell us more about where the economy has been than where it is going. That bias, coupled with the nonlinearity of outcomes for unemployment – when it rises it tends to do so rapidly – suggests the Fed is hardwired to hold policy too restrictive for longer than may be necessary.

A tapering of QT

Powell made clear at earlier press conferences that the decision to reduce the cap on what is known as quantitative tightening (QT) was a separate decision from changes in interest rates. The tapering of QT should not be taken as a signal that the Fed is easing policy.

QT is not the same as quantitative easing (QE) in reverse. The Fed has little experience reducing the size of its bloated balance sheet. It hit a wall in the fall of 2019, when the Treasury bond market briefly seized and forced the Fed to cut and bring an abrupt end to QT. To avoid a repeat, the Fed planned to taper the pace of QT to keep reductions in its balance sheet going on for longer.

That concept was not well-conveyed at the May press conference and the yield on the 10-year Treasury bond dropped on the news. That is the wrong direction for the Fed. Financial markets need to brace themselves for participants at the May meeting to clarify their stance on hikes and what changes to the balance sheet actually mean.

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Spillover effects

Delays to rate cuts elsewhere?

Last, but by no means least, the reserve currency status of the US dollar gives the Fed an outsized role in global financial markets. The flipside of the recent appreciation of the dollar against the currencies of nearly every major trading partner reduces the costs of imports but fuels inflation abroad. That could delay rate cuts for countries which are much weaker than the US and were hoping to get an extra lift by rate cuts.

The relationship between the Fed and other central banks is not as close as it once was, as was discussed in the April 2024 Global Navigator. Emerging markets have shored up their holdings of foreign exchange reserves to better defend their currencies. That has dampened but not eliminated the effect that the Fed could have on the timing and pace of rate cuts by other central banks.

Bottom line

The Clash's song, "Should I Stay or Should I Go" underscores the limbo that the Fed now finds itself in. The band broke up before that song became a hit. It showed up in a TV ad for jeans, nearly a decade after it was released, which propelled it to the top of the charts.

Fissures within the Fed have formed but are not as deep as that of a rock band. Powell is intent on keeping the music playing, even as the drinks get watered down. The goal is to keep as many people on the dance floor as possible and the party going, long after the drinks have stopped flowing.

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Economic Forecast — May 2024

	2023	2024	2025	2023:4(A)	2024:1(A)	2024:2	2024:3	2024:4	2025:1	2025:2	2025:3	2025:4
National Outlook												
Chain Weight GDP[1]	2.5	2.5	1.7	3.4	1.6	2.4	1.8	1.3	1.4	1.6	2.4	2.5
Personal Consumption	2.2	2.7	2.0	3.3	2.5	3.4	2.2	1.5	1.7	1.9	2.6	2.5
Business Fixed Investment	4.5	2.8	2.4	3.7	2.9	1.9	2.3	2.1	2.3	2.2	3.1	3.4
Residential Investment	-10.6	4.2	2.7	2.8	13.9	0.5	-3.1	-0.4	4.0	4.9	6.8	6.5
Inventory Investment (bil $ '17)	44	53	74	55	36	48	59	70	73	69	73	82
Net Exports (bil $ '17)	-928	-1017	-1091	-919	-973	-1011	-1031	-1051	-1071	-1083	-1097	-1113
Exports	2.6	1.9	3.6	5.1	0.9	0.0	4.0	3.8	3.3	3.9	4.4	4.9
Imports	-1.7	4.0	4.7	2.2	7.2	4.4	5.1	5.0	4.6	4.1	4.7	5.1
Government Expenditures	4.1	2.5	0.5	4.6	1.2	1.3	1.1	0.5	0.3	0.2	0.3	0.3
Federal	4.2	1.7	0.6	2.4	-0.2	1.0	1.5	0.4	0.4	0.3	0.6	0.6
State and Local	4.0	3.0	0.4	6.0	2.0	1.5	0.9	0.6	0.2	0.2	0.2	0.2
Final Sales	2.9	2.5	1.6	3.9	2.0	2.2	1.6	1.1	1.4	1.7	2.3	2.3
Inflation												
GDP Deflator	3.6	2.6	2.5	1.6	3.1	3.1	2.3	2.5	2.4	2.4	2.5	2.5
CPI	4.1	3.2	2.3	2.7	3.8	3.9	2.5	1.9	1.4	2.3	3.1	3.1
Core CPI	4.8	3.6	2.7	3.4	4.2	3.6	3.1	2.7	2.5	2.5	2.5	2.5
Special Indicators												
Corporate Profits[2]	5.1	4.7	2.9	5.1	8.2	12.3	9.1	4.7	4.3	0.8	1.7	2.9
Disposable Personal Income	4.2	1.7	3.2	2.0	1.1	1.5	2.5	3.1	4.2	3.1	2.9	3.2
Housing Starts (mil)	1.42	1.42	1.47	1.48	1.42	1.40	1.43	1.44	1.44	1.46	1.49	1.50
Civilian Unemployment Rate	3.6	3.8	4.1	3.8	3.8	3.8	3.8	3.9	4.0	4.1	4.1	4.1
Total Nonfarm Payrolls (thous)[3]	2936	2131	251	617	791	649	433	258	91	6	22	132
Vehicle Sales												
Automobile Sales (mil)	3.1	3.1	3.1	3.1	3.0	3.0	3.1	3.1	3.1	3.1	3.1	3.1
Domestic	2.3	2.1	2.1	2.3	2.1	2.1	2.2	2.1	2.1	2.1	2.1	2.1
Imports	0.9	0.9	1.0	0.9	0.9	1.0	0.9	1.0	1.0	1.0	1.0	1.0
LtTrucks (mil)	12.4	12.6	12.9	12.6	12.4	12.7	12.7	12.8	12.8	12.9	13.0	13.0
Domestic	9.9	9.9	10.0	9.9	9.9	9.9	10.0	10.0	10.0	10.0	10.0	10.0
Imports	2.5	2.7	2.9	2.6	2.5	2.8	2.7	2.8	2.8	2.9	3.0	3.0
Combined Auto/Lt Truck	15.5	15.7	16.0	15.7	15.4	15.7	15.8	15.8	15.9	16.0	16.1	16.1
Heavy Truck Sales	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.0	16.2	16.5	16.2	15.9	16.2	16.2	16.3	16.4	16.5	16.5	16.6
Interest Rate/Yields												
Federal Funds	5.0	5.4	4.5	5.3	5.3	5.4	5.4	5.3	5.1	4.7	4.3	4.1
10 Year Treasury Note	4.0	4.4	3.5	4.4	4.2	4.6	4.4	4.3	4.0	3.5	3.3	3.1
Corporate Bond BAA	5.9	6.0	5.5	6.2	5.7	6.0	6.0	6.2	5.9	5.5	5.4	5.3
Exchange Rates												
Dollar/Euro	1.08	1.09	1.10	1.08	1.09	1.08	1.09	1.09	1.10	1.10	1.10	1.10
Yen/Dollar	140.5	147.6	138.8	147.8	148.5	150.0	147.0	145.0	143.0	140.0	137.0	135.0

[1] in 2023, GDP was $22.4 trillion in chain-weighted 2017 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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