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# WEEKLY ECONOMIC COMMENTARY

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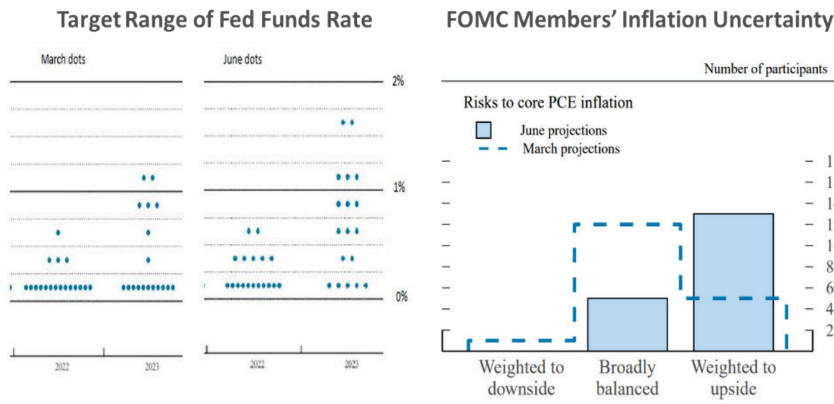
This week's meeting of the Federal Open Market Committee (FOMC) gave further evidence of recovery: In its quarterly Summary of Economic Projections (SEP), the "dot plot" outlook showed that a majority of Fed governors expect a higher federal funds rate by 2023. In March, the median called for unchanged rates until at least 2024. While the direction of the change is logical (few would argue that the policy rate should stay near zero in perpetuity), a documented timeline makes the shift feel tangible.

With the possibility rising of a change in policy, the Fed will face greater scrutiny in its decision-making. Its responses to the COVID-19 crisis were swift, helpful, and applauded by investors. It now faces the challenge of pulling back a bit without upsetting markets.

Inflation and employment metrics are both in perplexing states that may complicate the Fed's upcoming decisions. Much ink has been spilled on the topic of inflation, including our own recent commentaries (here and here). In his post-meeting press conference, Fed Chair Jerome Powell reiterated his view that temporary bottlenecks were responsible for the bulk of recent jumps in prices, and the FOMC would appear to agree. The SEP inflation forecast for 2022 rose, but expectations for 2023 did not change much. That said, a majority of FOMC participants indicated inflation risk is to the upside.




Sources: Federal Reserve, FT

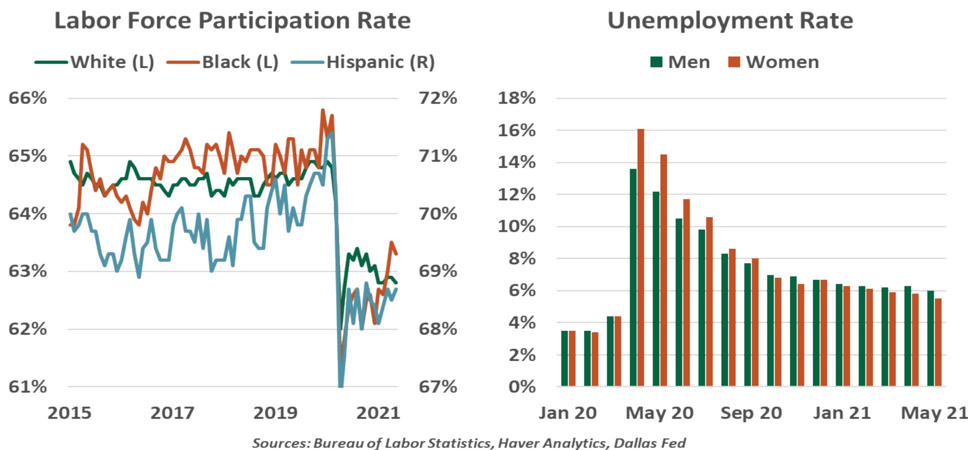
The Fed is a lightning rod for inflation concerns, as it has a mandate to maintain stable prices. Some have called for immediate reductions in asset purchases to head off problems later on. However, much of the current attention is misplaced. The Fed has no tools or remit to advance vaccines, bolster semiconductor supply chains or control the prices of used cars. Changing course to battle inflation that proves fleeting could unsettle markets and put the booming recovery at premature risk.

Excessive focus on inflation also takes attention away from the other side of the Fed's dual mandate: maximum employment. While they have not set an explicit target, Powell

and other Fed governors have expressed the desire to recreate the strong and inclusive state of the labor market through 2019, when the unemployment rate held at 3.5% and job growth and wage gains accrued to workers across races and income levels. With current unemployment of 5.8% and labor force participation still well down from its pre-pandemic standing, the labor market has a lot of ground to retrace.

In April, Powell said the FOMC would need to see "a string of months" of job creation of a million jobs or more as evidence of recovery. That statement came on the heels of the report of more than 900,000 jobs created in March; a million seemed to be in sight. Job creation since then, however, has been tepid: March was revised down, April was far below expectations, and May was still well below potential. The problem may be on the supply side: a variety of temporary factors are holding workers back from the labor markets. These constraints should ease significantly between now and the end of the year.

The inclusiveness of the employment recovery is improving. Earlier in the recovery, white workers returned to work earlier, and men experienced less of a decline in employment. For the past several months, however, labor force participation and employment by women and minorities have all shown gains. There is still ground to cover; Fed chair Powell indicated he is still seeking more broad-based and inclusive outcomes.




*Sources: Bureau of Labor Statistics, Haver Analytics, Dallas Fed*

**Labor markets still have considerable room for improvement.**

The Fed's next step will need to be a tapering of its asset purchases. It is still purchasing $80 billion of U.S. Treasuries and $40 billion of mortgage-backed securities every month, the same pace of purchases it began in the heat of COVID-19 shutdowns in March of 2020. While dislocations remain, the economic outlook is comprehensively better today than it was last year, and the same level of accommodation is no longer needed. A substantial portion of the liquidity the Fed has pushed into the financial system over the past 15 months has returned unused.

The Fed will be careful in its communication so as to not upset markets with incomplete guidance, as happened in the 2013 "taper tantrum." Earlier in 2021, Powell said the FOMC wasn't even "thinking about thinking about" any changes. As the months have progressed and the indicators have improved, officials have gradually changed their language: In his press conference this week, Powell admitted the FOMC was "talking about talking about tapering."

The discussions will likely intensify in the coming months. The Fed's annual Jackson Hole conference (which will apparently be held in person again this year) has often been used to provide signals, and we'll get an updated set of forecasts and expectations from the FOMC in September.

If the U.S. economy continues to progress as we anticipate it will, the Fed's asset purchases will be reduced starting in January and its balance sheet will be stabilized in the middle of 2022.

It should be noted here that "tapering" is not "tightening." Even at a reduced rate, asset purchases by the Fed will still be expanding, adding to the level of reserves in the financial system. But beginning to taper would start the countdown towards potential increases in interest rates, which would be restrictive. Current readings from the Fed, the markets, and private forecasters suggest that juncture may arrive sooner than previously thought. This prospect has led long-term interest rates and inflation expectations lower.

**Tapering is on the horizon, but rate increases are further in the distance.**

To be sure, the dot charts are not the best signal of Fed policy. Each depends on the forecast of the contributor; as Chair Powell said in his press conference, forecasters have a lot to be humble about. Some dots come from more influential members of the FOMC, but we can't tell which ones they are.

Nonetheless, the messaging from Washington this week marks a progression. This is good news, because it reflects economic improvement. But it also begins a delicate period ahead for the Fed.

## Material World

As U.S. economic activity gathers momentum, the economy is facing its biggest inflation scare in four decades. The headline consumer price index (CPI) jumped 5% year-over-year in May. As discussed below, some quirks have contributed to this outsized result. But recent surges in commodity prices are harder to dismiss.

Raw materials like aluminum, copper, oil, iron ore and lumber have all been in short supply in recent months, and their prices have hit record highs. Copper, a metal closely linked to global growth owing to its usage in housing and electronics, had soared above $10,000 per metric ton. Gasoline futures prices doubled over the past year, while lumber futures had more than tripled at their peak last month.

There is little doubt that the economic reopening has contributed to higher demand for goods and services that utilize major commodities in many countries. However, not everything is explained by improving demand. Financial and supply-side factors have also been at work.

Factories and mines were severely disrupted by COVID-19. Inventories have been depleted, leading to pricing premiums. As we wrote here, supply chain disruption has contributed to shortages of materials and delays in their receipt. Both have added to increases in their costs.

Markets have also been a factor in the recent surge in prices of minerals, metals and energy. Investors have been turning towards commodities as a way to hedge against inflation, which has become a central concern this year. In the wake of this week's messaging from the Federal Reserve, though, futures prices for metals have been in steep retreat. Hopefully, this will reduce pressure on spot prices in the weeks ahead.

Commodities play a vital role in the economy, but studies show their diminished importance, "both as share of final output and as a source of exogenous shocks to the economy." According to research by economists at the Federal Reserve Bank of New York, commodities play a more limited role in the cost of production than they used to, as businesses have become more efficient.

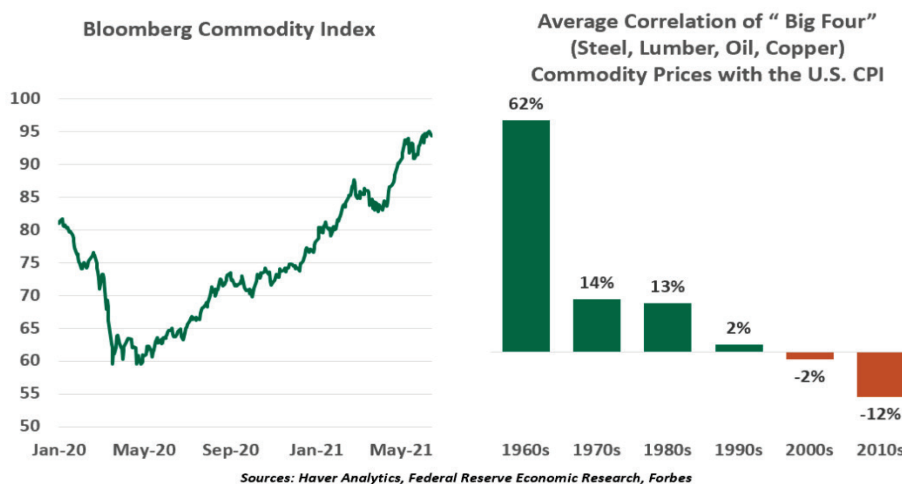
In advanced economies, goods represent a much smaller share of consumer inflation than do other costs. Labor is the largest expense in the production of most commodities (less food), which account for a little over 20% of the U.S. consumer price basket. Technological innovations have

allowed producers to use raw materials more efficiently, which limits the inflation generated by resource prices.

By contrast, services constitute more than 60% of the basket; labor is virtually the sole factor of production in these cases. As a result of these factors, the correlation of key commodity prices with the CPI has weakened in recent decades and turned negative in the last 10 years.

All that said, surging commodity prices cannot be ignored entirely. Manufacturers are taking a hit on their margins from the temporary stress in raw materials markets and are under increasing pressure to pass the burden on to consumers. Commodity prices also provide an important signal on the balance between supply and demand (a key factor in inflation) in an economy, and usually react more rapidly to changes in the economy than do prices of final products.

**The influence of commodity prices on consumer prices is not what it used to be.**



*Sources: Haver Analytics, Federal Reserve Economic Research, Forbes*

Lumber became one of the hottest commodities earlier this year as housing boomed and supply issues limited the availability of wood. But prices in this arena have declined significantly from their overall highs. A shutdown in May of the East Coast's main pipeline for refined fuels pressed gasoline prices sharply higher, but the pressure receded once the pipeline resumed operation. Copper prices have tumbled to their multi-week lows on the back of China's decision to release key industrial metals reserves and a reversal of sentiment surrounding inflation risk.

These developments support our view that elevated commodity prices are likely to be transitory. After producers work through supply chain bottlenecks, pent-up demand will fade. The steamy commodities markets will likely lose steam over the balance of this year.

## Minutiae

Sometimes, small things can create big problems. That is certainly true in the measurement of U.S. inflation, where a small handful of items are creating outsized movements.

With the U.S. economy roaring back to life, concerns about overheating have dominated our conversations with clients over the past several months. We've characterized many of the price movements as transitory, but not everyone has accepted that explanation. With a selection of products getting more expensive and labor in short supply, more persistent inflation is certainly possible. As we explored this week, the Fed sees risks on this front to the upside.

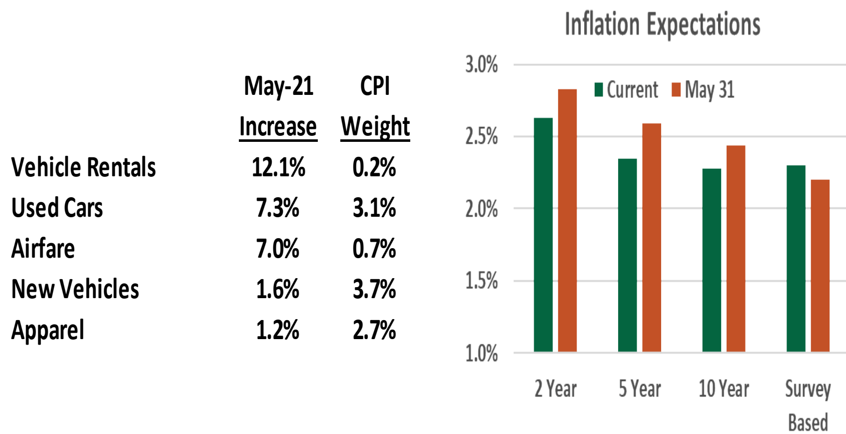
A look at the most recent consumer price index (CPI) report offers reasons for calm. Five categories, which account for just over 10% of the basket of goods and services considered in the

CPI, accounted for two-thirds of the inflation recorded last month. None of these prices are likely to continue upward at their recent pace.

Taking car rental rates as a case in point, fleets were reduced aggressively last year as travel shut down; rental companies rebuilt them cautiously as travel began to recover. The result has been a significant imbalance between demand and supply, which has allowed rental companies to charge a premium. Over time, car lots will be replenished; auto production has rebounded after chip shortages slowed assembly lines earlier this year. This will limit future increases in rental rates.

Similar patterns will be seen elsewhere as supply responds. As noted earlier, lumber provides an interesting precedent; scarce and expensive two months ago, board prices are now falling rapidly. Not only is it unlikely that extraordinary price increases will be sustained, it is also possible that some trends will eventually be reversed.

**Investors are recognizing the transitory nature of recent inflation readings.**



| | May-21 Increase | CPI Weight |
|---|---|---|
| Vehicle Rentals | 12.1% | 0.2% |
| Used Cars | 7.3% | 3.1% |
| Airfare | 7.0% | 0.7% |
| New Vehicles | 1.6% | 3.7% |
| Apparel | 1.2% | 2.7% |



*Sources: BLS, Bloomberg, Federal Reserve Bank of Philadelphia*

Numerically, these isolated incidents are unlikely to have long-term consequences for the CPI. But they do have the potential to affect our perceptions of inflation, which can have a strong influence on the evolution of actual inflation. Fortunately, the most recent readings from financial markets show reduced inflation expectations; further, near-term readings are higher than those for longer terms, consistent with a thesis that current pressures will not last.

That may be cold comfort for vacationers needing vehicles this summer. But for investors, having perspective on the inflation picture has cooled anxieties.

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