US Macroeconomics

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Why a Soft Landing Is Unlikely

The probability of a soft landing is low when inflation is high, and unemployment is low. Why? Because the Fed must tighten monetary policy enough to weaken demand relative to supply. This is difficult when prices are rapidly rising, and the jobs market is tight as it is now. **Monetary policymakers essentially are forced to err on the side of excess tightening to break the inflationary cycle**. This makes a recession nearly unavoidable.

The chart below shows the year-over-year rate on the consumer price index (CPI) and the unemployment rate. High inflation is defined as annual price gains more than 5%. Low unemployment is considered when the rate is around 5% or lower. A line demarcating the 5% threshold is also shown.

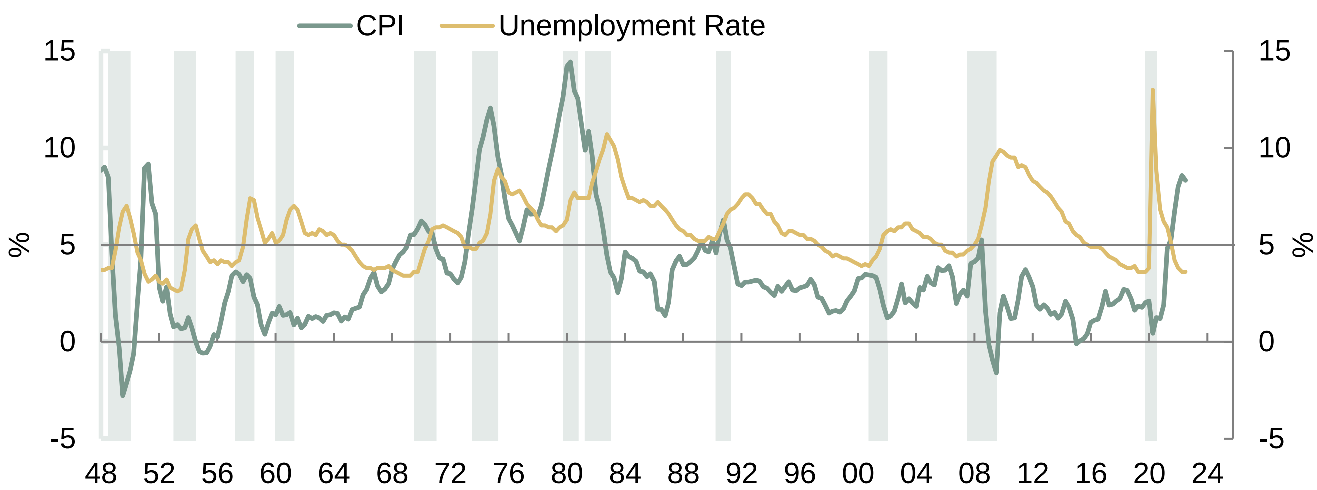
There have been 12 recessions in the last 80 years. In seven of these, the economy experienced high inflation and relatively low unemployment except one instance (1981). In all seven periods the economy went into recession. There were no soft landings. Hence, we expect history to repeat.

During the 1945 to 1948 business cycle, inflation was 9% and unemployment only 3.7%. A recession began in late 1948. Fast forward to the long 1960s expansion when CPI was running over 6% and unemployment rate was just 3.4%. Recession strikes.

The deep 1973 to 1975 recession was preceded by 8%-plus inflation and 4.8% unemployment. Arguably this is most like the current environment.

The 1980 downturn was preceded by double-digit price gains and unemployment only slightly above 5%. When the 1981 recession hit, the CPI was rising almost 10% annualized despite a 7%-plus unemployment rate. Perhaps the best chance for a soft landing was in 1990 when both inflation and unemployment were around 5%. Instead, the economy entered a recession in the middle of that year.

There has been one soft landing. It occurred in 1995 after the Fed had deftly raised interest rates 300 basis points (bps) over the preceding 12 months. At the time, CPI was only 2.5% and unemployment was above 6%, which is much different than today's high inflation/low unemployment rate backdrop. **With the Fed pledging more interest rates hikes, the probability of a soft landing remains low**. Investors take note.



Source: Haver, Bureau of Labor Statistics, SMBC

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