US Macroeconomics

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Does "No Landing" Lead to "Hard Landing"?

In the 12 months ending in March, the headline and core personal consumption expenditures (PCE) deflators are up 2.7% and 2.8%, respectively. The Fed is committed to bringing inflation down to 2%. Policymakers will not cut rates until they are confident they will achieve their target. **Unless the Fed abandons its goal and settles for low to mid-2% price growth, the most likely way the economy achieves 2% inflation is from a recession.**

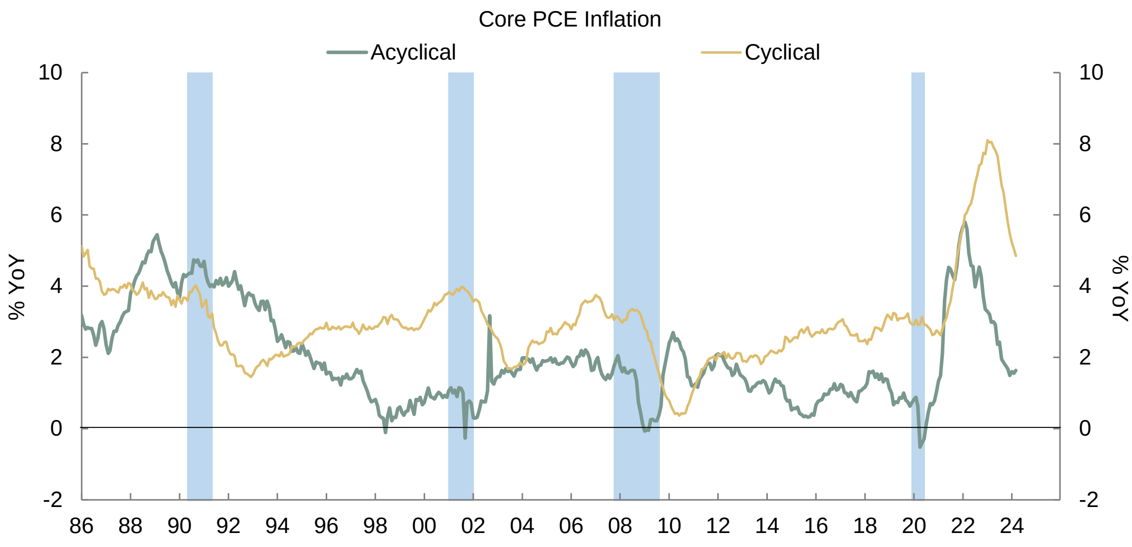
Below, we chart the San Francisco Fed's breakdown of the Core PCE deflator into an acyclical and cyclical component. The former is comprised of 92 series that are not correlated or influenced by the change in real GDP. This includes components such as education and healthcare. The latter is comprised of 30 series that are highly correlated or influenced by the business cycle. This includes components such as housing/rents and recreation. Basically, **acyclical items are consumer staples or necessities while cyclical items are discretionary.**

Acyclical prices have risen just 1.6% over the past year and have been below 2% for eight straight months. Absent supply-side disruptions, it is hard to see acyclical inflation rising much from here. Thus, further progress on core inflation will likely have to come from the cyclical side which, definitionally, requires slower demand and growth.

Meanwhile, cyclical prices peaked at 8.1% in January 2023 and have slowed sequentially every month since then, to 4.9% currently. But if the economy remains robust, meaning underlying real GDP growth remains around 3% and the unemployment rate hovers near 4%, then it is doubtful that the slowdown in cyclical inflation will persist. **For core PCE inflation to fall to 2%, cyclical prices (a 38% index weighting) would need to fall to *2.6%* from 4.9% currently — assuming acyclical inflation (62% weight) remains stable.**

Eventually, and perhaps sometimes soon, the year-over-year growth rate in cyclical prices will level off at a pace far above 2%. The upshot is that the Fed will have to keep interest rates high enough, and for long enough, to weaken discretionary spending. But given the timing of these lags, we worry the Fed could be too restrictive for too long, which has happened in every previous business cycle when the inflation rate was meaningfully elevated. **Except in the pandemic experience, in every past instance, cyclical inflation did not come down until the economy was already in recession**, as shown below.

Is there any way for the Fed to stem discretionary spending (and thus cyclical inflation) without an attendant recession? In theory, a surge in potential GDP growth that opens up economic slack could push inflation lower. But if this was happening, then we would not have seen the recent upswing in the three- and six-months rate of inflation.



Source: San Francisco Fed, Haver, SMBC Nikko

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