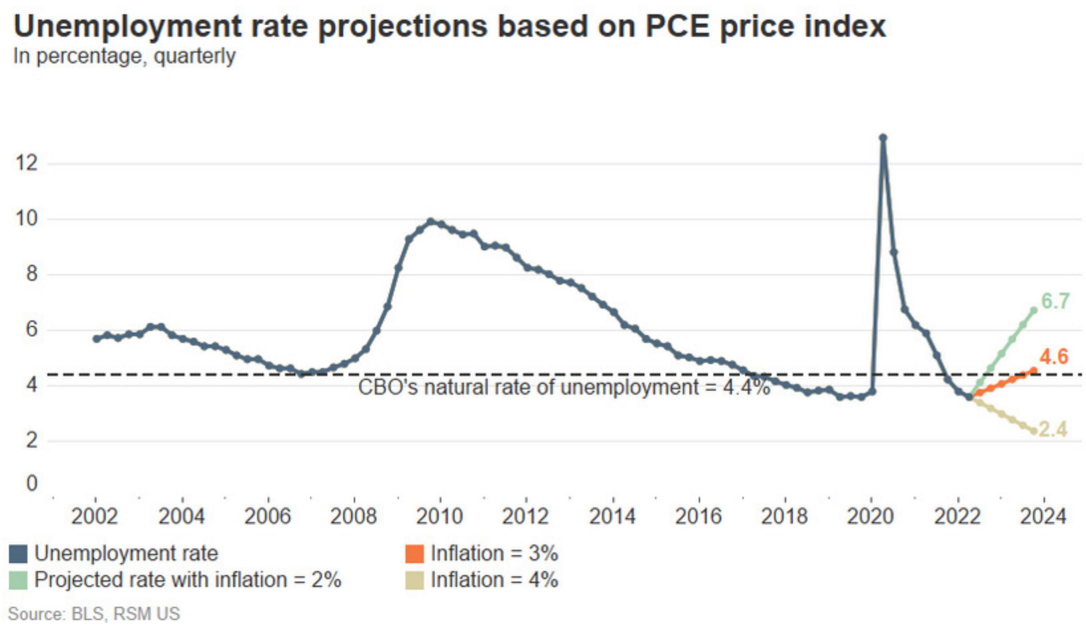
August 31, 2022

Unemployment Target

The unstated part of the Federal Reserve's inflation-fighting campaign is that a bunch of people will have to lose their jobs. The plan relies on the "Phillips Curve," which Milton Friedman and others found shows a short-term inverse relationship between unemployment and inflation. It's not clear this logic applies in the current situation, but the Fed has few other choices.

But *how much* must unemployment rise for inflation to drop back to the Fed's target zone? The economics team at RSM recently modeled this question, using both the Phillips Curve plus a proxy variable to account for supply chain deficiencies. This chart shows the result.



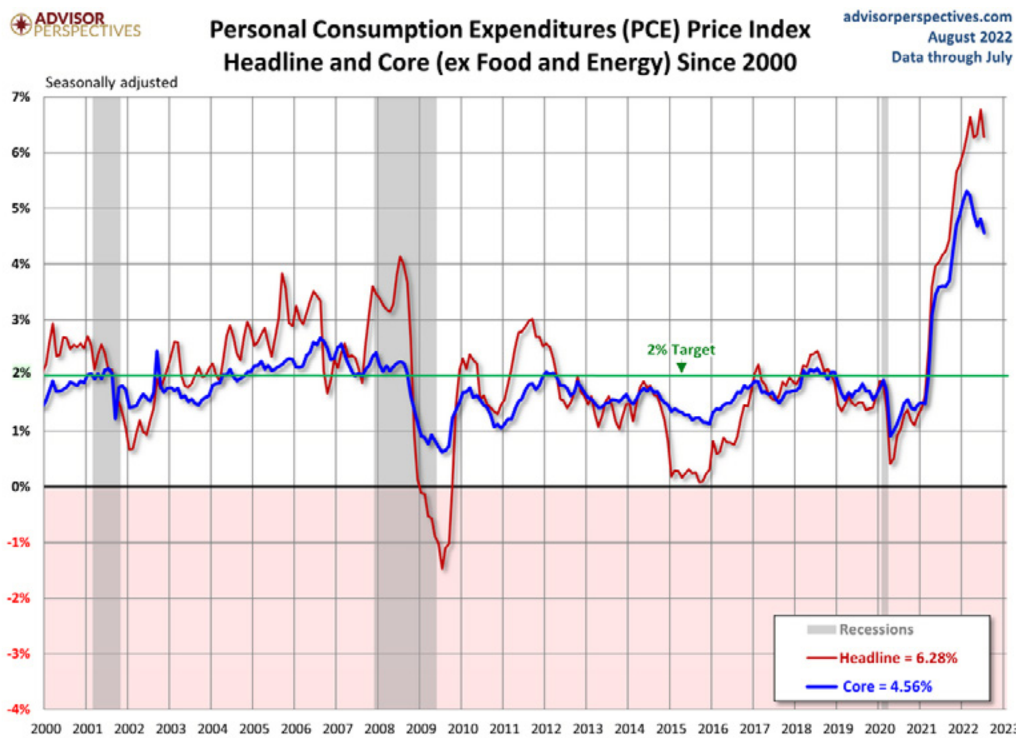
Source: RSM

Using the Fed's preferred PCE inflation gauge, RSM estimates unemployment (currently 3.5%) must almost double to 6.7% in order to achieve 2% inflation. Changing the target to 3% inflation would require "only" 4.6% unemployment.

Given the labor market's strength, these might seem tolerable. That's easy to say when you aren't the one being fired… but tolerating high inflation might be even worse.

Inflation Top?

This chart shows the year-over-year change in the Personal Consumption Expenditures (PCE) Price Index, the Federal Reserve's favorite inflation measure. The Fed's 2% target is in green. You can see PCE was below target for almost the entire period between the Great Recession and 2021. Then, as if trying to recover lost time, it shot sharply higher.



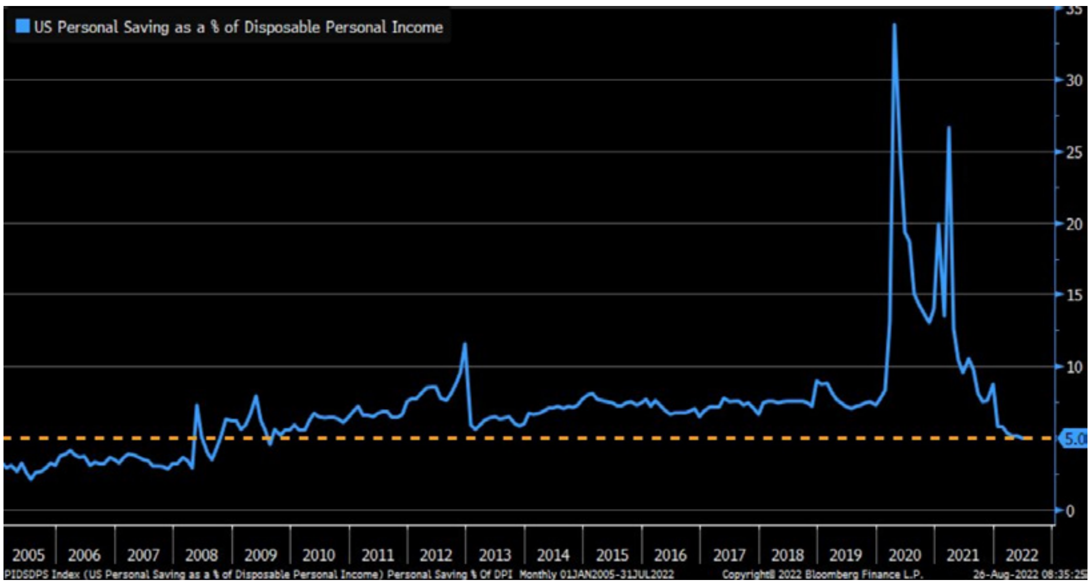
Source: [Advisor Perspectives]

Yet the chart may also show a little hope. Both core and headline PCE seem to have at least stopped rising in the last few months, and core PCE may actually be turning down. They're still far above 2% so we don't want to get too excited. Even a drop to 0% annual growth would leave prices at painfully elevated levels. Nonetheless, any change in direction helps.

Savings Spiral

How much of their income do Americans save? It's a surprisingly complex question. The "personal saving rate" is derived from other data: personal income minus outlays and taxes then expressed as a percentage of disposable personal income. In other words, it's what is left over after people meet other obligations and desires.

The chart shows personal savings held mostly steady in the post-2008 era before some wild volatility when COVID struck. But the recent past is more troubling.



Source: [Liz Ann Sonders]

As of July, personal savings stood at 5%, the lowest level since 2009. But look back in the chart and you'll see it was lower still in the years leading up to that recession. How does that make sense?

Generally, people save more when they're concerned about the future. They save less when they feel confident in their future earning power. Maybe today's strong labor market is giving more people incentive to spend freely. Or maybe inflation is *forcing* them to spend more freely.

In either case, lower savings now mean less capital for future investment. And that's probably not good for anyone.

Dry Bulk Rates

We've shared several charts on shipping costs recently. They're important not simply for the costs, but because they help reveal other economic changes.

This chart is the Baltic Exchange Dry Index. This is different from container or tanker rates. It shows the cost of moving "dry bulk" cargo like coal, iron ore, grains, etc. As you can see, these rates have been dropping since a peak last spring and are now at the same level as mid-2020.

Source: [Liz Ann Sonders]

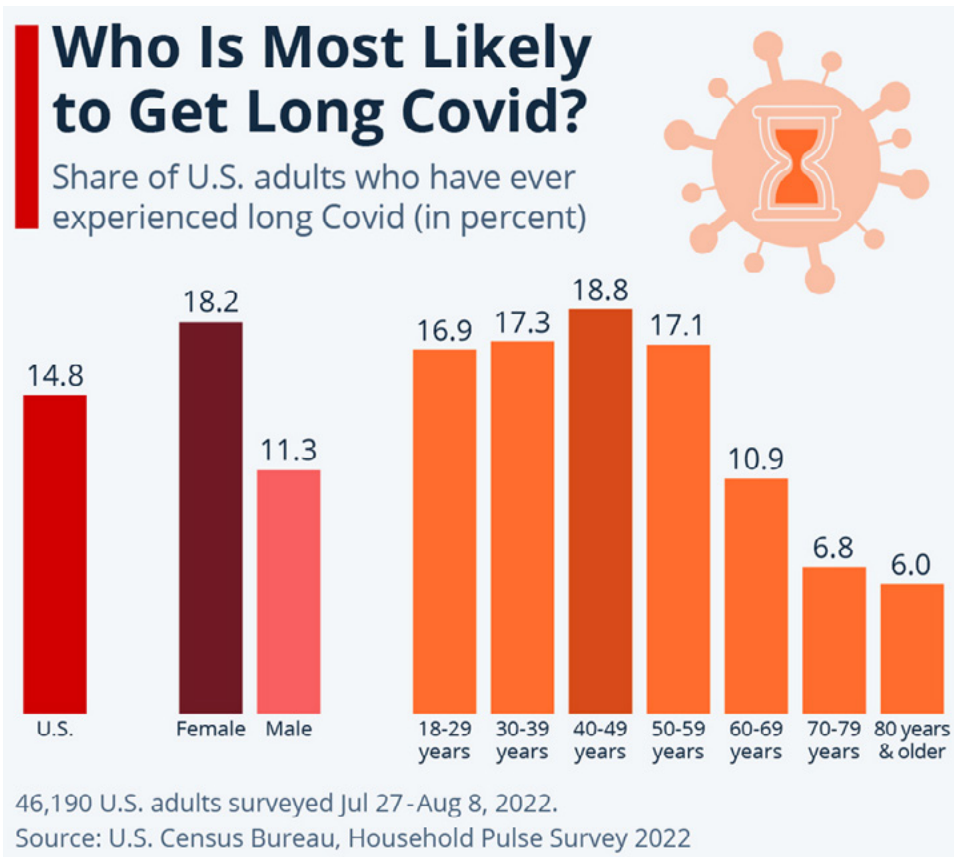
Dry bulk cargo is associated with economic growth. Businesses import raw materials when they foresee higher demand for their finished goods. Iron ore gets made into steel that goes into new buildings, for instance. Less building activity will mean less iron ore demand—and more idle shipping capacity that pushes rates down.

With that in mind, it looks like the fast-rising shipping rates in early 2021—as the world began recovering from COVID—may have run their course. Dry bulk shipping rates are headed back to where they were before the pandemic. Economic growth may be headed there as well.

Long COVID

"Long COVID" is undoubtedly aggravating the labor shortage, but quantifying the effect is hard. People have varying degrees of sickness and disability. This Census Bureau survey data suggests something like 17-18% of US adults aged 18-59 have experienced extended COVID illness. That's a significant portion even if most are still able to work.

Note also the much higher prevalence in women. This may help explain why shortages seem worse in occupations with high numbers of women (teachers, retail). The virus may be out of the headlines but it's still affecting the economy.



Source: Statista

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Best regards,

John & Patrick

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