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A Brief Policy Review

With decades of unconventional and highly stimulative policies and then, having successfully urged Congress to inject cash directly to households via PPP and other programs, the Fed let the inflation genie out of the bottle. I agree with the Wall Street Journal Editorial Board, this was the Fed's greatest monetary policy mistake since the 1970s. That is actually a high bar, since the Fed embarked on a horribly misguided set of monetary policies in 2008 and, to this day, has not rolled them back in a substantive manner.

Inflation was let loose and harmed our lower income households. In March of 2022 the Fed embarked on a rate hike program, to fight the inflation they created. The press and other forecasters have labeled these rate hikes "historic," in that they have been aggressive relative to other rate hike regimes. However, the level rates are at today pales in comparison to the rate hikes the Fed was forced to implement during an earlier battle with inflation back in the late 1970s. Rates are not high enough to put a major dent in the inflation we face. Real long-term interest rates are currently negative or near negative, depending on which market yield one looks to. Conventional wisdom is correct in this case – not only are negative interest rates bad, but they are stimulative. Thus, the Fed's policy is still stimulative, despite their recent rate hikes.

Proclaiming that the recent hikes are historic misses the point. The Fed's current target midpoint rate is 4.625 percent, which does not compare to the 20 percent target rate that the Fed utilized to successfully fight inflation in the early 1980s. CERF is not advocating for a 20 percent rate. However, 4.626, as well as the 4.875 that is expected in March, are simply not high enough.

The Fed's overly easy credit policies since 2008, including their policies during the Pandemic, have been ad hoc. They represent an overly-activist Fed. There is a body of literature that recommends that the Fed pursue its policies with a rational, rules-based policy. In the absence of this rules-based approach, the Fed's policies are harming the economy and lower income households.

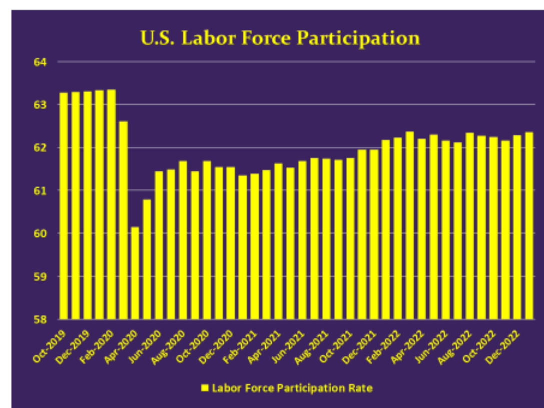
Sadly, fiscal policy has been over-activist as well. The multi-Trillion dollar spending policies that were legislated *might* have been defensible in the immediacy of the Pandemic, but they were not advisable in 2021 and 2022. Yet, trillions of dollars of additional spending packages have been authorized in the past 18 months, long after economic recovery was under way. The CBO projects that Federal debt as a percentage of GDP will rise secularly,

from 98 percent of GDP in 2023 to 118 percent in 2033.

The activist and ad hoc nature of monetary and fiscal policymaking is a part of overall policy uncertainty in Washington DC. This uncertainty comes from the policies mentioned above, and it also includes the lack of proper government function, such as the ongoing political machinations regarding the debt ceiling and the closed-door manner in which the US budget has been legislated for years now. This uncertainty is harmful to the economy, particularly, to long-term investment. Investment expenditures impact the economy immediately, as soon as funds are allocated to an investment project, and they benefit economic capacity and support higher income in the future, once the projects are completed. But, they are long-term, and decision-makers will be hesitant to pursue a project that might not pay off until 10 years forward or more, when the policy environment is uncertain.

A Comment on the Labor Market

Other forecasters dwell heavily on the unemployment rate as a measure of the health of the labor market. Our clients should understand that the unemployment rate has become essentially meaningless. This is because the unemployment rate is just as impacted by labor force (the number of persons looking for a job or that have a job) as it is by job creation. Labor force growth has been anemic at best since the large decline in the size of the labor force during the early days of the Pandemic. This is seen best through the labor force participation rate, which is the labor force proportion of population. It was 63.3 percent pre-Pandemic. Despite the growth of GDP and jobs to well above pre-Pandemic levels, the labor force participation rate, currently at 62.4 percent, is still substantially lower than its pre-Pandemic high.

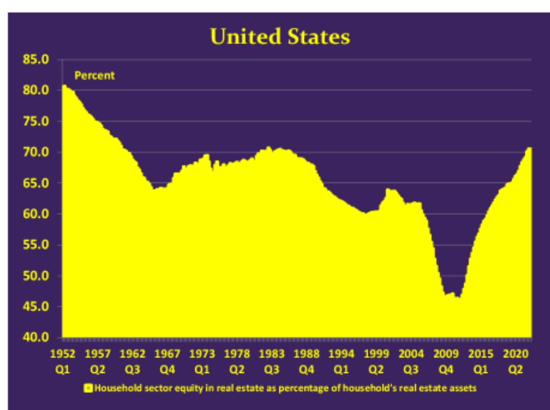


The Household's Balance Sheet

There is much commentary by forecasters and the financial media on the mixed signals coming from alternate macroeconomic indicators in the past few quarters. One way to gain insight into the underlying health of the economy is to utilize data on the household and non-profit sector's balance sheet.

The measure of household sector equity

in real estate as a percentage of their assets provides a meaningful lens into the vitality of the household sector. This measure is valuable because it nets out the liabilities (mostly the mortgages due) from the gross real estate asset value, before dividing into the real estate asset value. The most recent data, from 2022 Q3, is 70.5 percent.

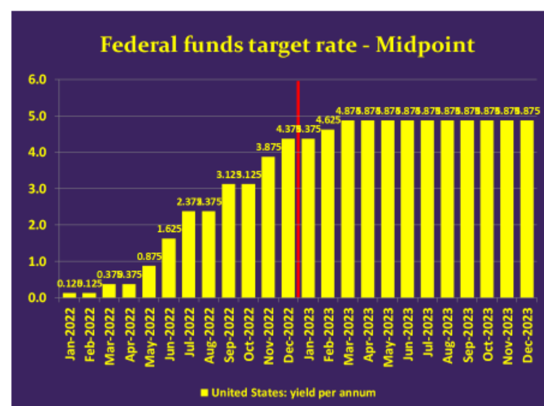


This value is an above average number in light of history since the 1960s, as shown by the chart above. It provides evidence that the household sector overall is indeed healthy.

The Forecast

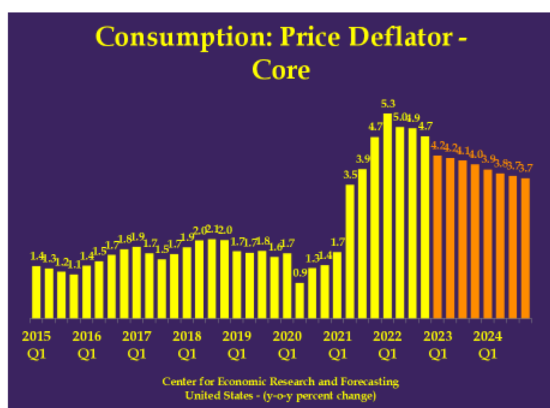
The apparent health of the household sector's balance sheet provides support for economic activity over the next 8 quarters. There are other positive factors. Unemployment claims are low and job openings are high. However, there are negative factors as well. Housing has responded to higher mortgage rates, as one might guess. However, many long rates have already come back down from their highs. CERF forecasts that housing will experience a cyclical contraction in 2023, but then rebound in 2024.

Our assumption for Fed rate policy during the forecast horizon is for a 25 basis point hike in March, and no further hikes. We do not have interest rate cuts in our baseline assumption. However, we note here that a rate cut by late 2023 is not out of character for this Fed, and markets are predicting such a cut. This would be despite ongoing inflation at a level substantially higher than the Fed's target.



Having said this, I bring to our clients attention that there is a risk that the Fed will raise their inflation target, rather than continue to fight inflation, especially if end-of-2023 inflation rates are well in excess of three percent. This is a risk to our forecast of the Fed's policy rate. I am fearful that the Fed will double-down on its already misguided and unconventional policies by finding a justification to not fight inflation.

Our forecast of the Fed's preferred measure of inflation, at the quarterly frequency, will indeed be significantly above 3 percent at the end of 2023. We forecast 4 percent at the end of 2023 and 3.7 percent at the end of 2024.



Why is our forecast high relative to consensus? The Fed has not done enough to fight inflation. Their target rate, expected to be 4.875 percent, will not be enough to combat the episode of inflation that we are in.

CERF's baseline forecast is a no-recession forecast, based on the Fed ceasing its rate hikes, and based somewhat on the underlying health of the household sector. This informs our forecast for the next couple of quarters. For the second half of 2023 and for 2024, the ad hoc and overly-activist monetary and fiscal policies that are described above in this article will dampen economic growth. Our forecast is for 1.4 percent growth in the U.S. economy for 2024. This growth rate is a rate that is dramatically below the potential of the United States.

With our forecast of ongoing high inflation and slow economic growth, CERF is forecasting a stagflationary economy. That is, chronically lower economic growth accompanied by well above target inflation. Unfortunately, this also means poor economic mobility, growing economic equality, and increasing social unrest. Much of the logic of our forecast is driven by poor economic policies, policies that are harming the economy.