

A Note From Your Advisors

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THE MAIN, GOWIN, FISCHER, RICE GROUP

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One of the biggest debates going on in economic and policy circles is whether the Federal Reserve needs to continue to raise interest rates. The bitter medicine of sharply higher rates was necessary to curb inflation. And indeed inflation has come back down significantly to lower levels in the last year.

We will get additional data on inflation this week, but as of May 2023 the inflation rate – as measured by Consumer Price Index (CPI) – was 4.0%. Back in June 2022 it was 9.1% so it has been reduced by more than half. The last time we had a reduction in inflation this sharp was from July of 2008 (5.6%) to July of 2009 (-2.1%). However, as most investors remember this reduction was because of the Great Recession rather than tighter policy by the Fed.

Historically reductions in the inflation rate are accompanied by, or even caused by, two other things: recession and higher unemployment. Is it possible this time for the Fed to raise rates in such a way that, when combined with other structural changes happening in the economy, it doesn't result in a recession and doesn't require higher unemployment? This dream balancing act is what popular media have termed the "Goldilocks Scenario." The economy is not too hot, and not too cold.

A recession is usually defined as two consecutive quarters of shrinking US Gross Domestic Product (GDP). As you will see from the link, we actually had two consecutive quarters of negative growth in Q1 and Q2 of 2022. However, you didn't hear most people refer to that period as a recession simply because the unemployment rate at the time was around 3.6%. Typically during times of recession (shaded areas of the chart) the unemployment rate spikes up to high single digits. And this results in the cost of labor, otherwise known as the wages that people earn for doing their jobs, decreasing or remaining stable.

Unemployment figures released last week still put the figure at 3.6%. So why is inflation getting lower without higher unemployment? One theory is that lots of people who have been out of the labor force for years (and have therefore previously NOT been counted as "unemployed") are coming back into the labor force now. There is some evidence to support this. The percentage of people participating in the work force has been declining gradually since the Great Recession of 2007-09. But then it fell off drastically during the Covid shutdown, and has been increasing ever since. The increases are larger among women and 16-19-year-olds. So maybe it's just a matter of more women and teenagers getting jobs?

Let's be clear: the men and women who make policy decisions at the Federal Reserve are highly intelligent and possess much better data and expertise than we do. However, they watched their predecessors in the 70s mess up by failing to truly "anchor" labor costs at stable levels. This led to many years of higher inflation which really damaged the economy. These Fed policy makers are determined not to make the same mistakes, and they were all trained in a classical economic model that assumes that for inflation to be lower and REMAIN lower the cost of labor has to remain stable. Historically this has always required higher unemployment. So all those men and women making policy are looking for that same inverse teeter-totter relationship now.

Markets have clearly spent much of 2023 trying to move beyond the narrative of higher interest rates. However, we believe that unless and until the cost of labor is "anchored" at lower and stable levels, the Federal Reserve is likely to continue to raise rates more than the market would like. As portfolio managers we feel more comfortable seeking opportunity now than we did 6 or 12 months ago – but we remain cautious that investors are going to have to endure more pain at times, until we can sort out how much these higher interest rates are going to impact the economy and corporate earnings. Keep your seatbelt on....