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MACRO MORNING BRIEFING

May 20, 2024

Confronting The US Stagflation Meme

Memes and Themes

- Stagflation does not accurately describe the current outlook
- Evidence suggests the economy is slowly moving towards equilibrium
- Fed policy appears just restrictive enough

Neither the "Stag" nor the "-flation"

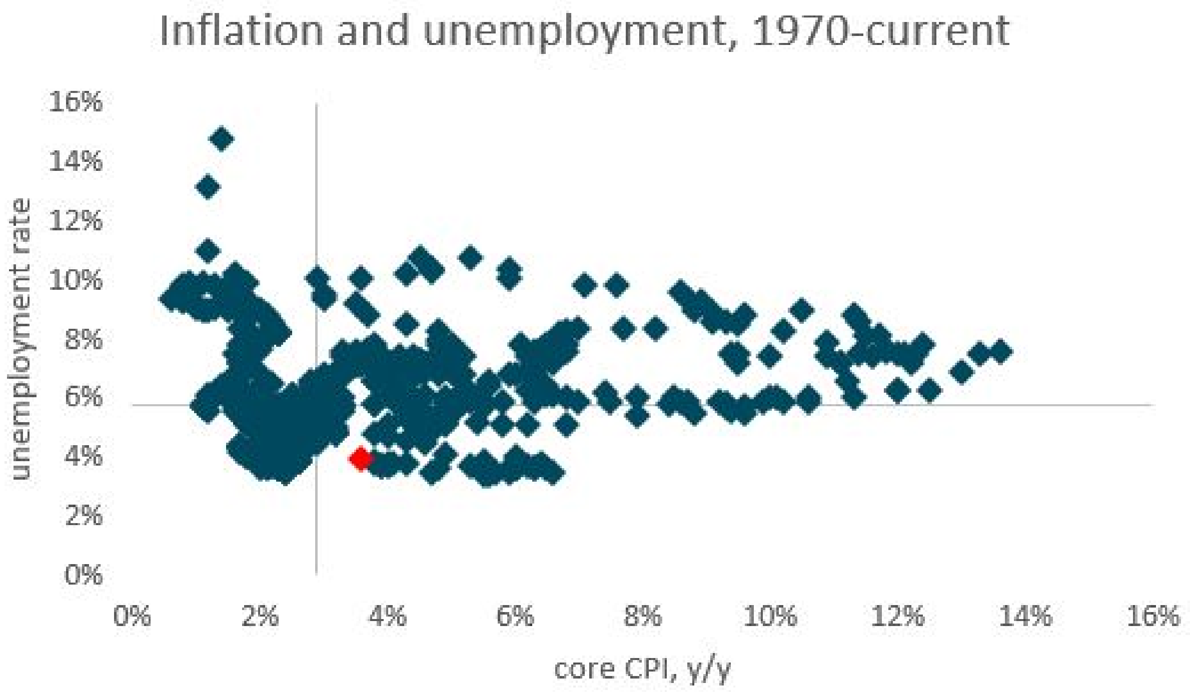
Stagflation. It’s been one of a number of market memes and themes populating the financial news cycle lately. It’s understandable to try to categorize what’s going on with tempting narratives. However, we believe the evidence does not support this theme.

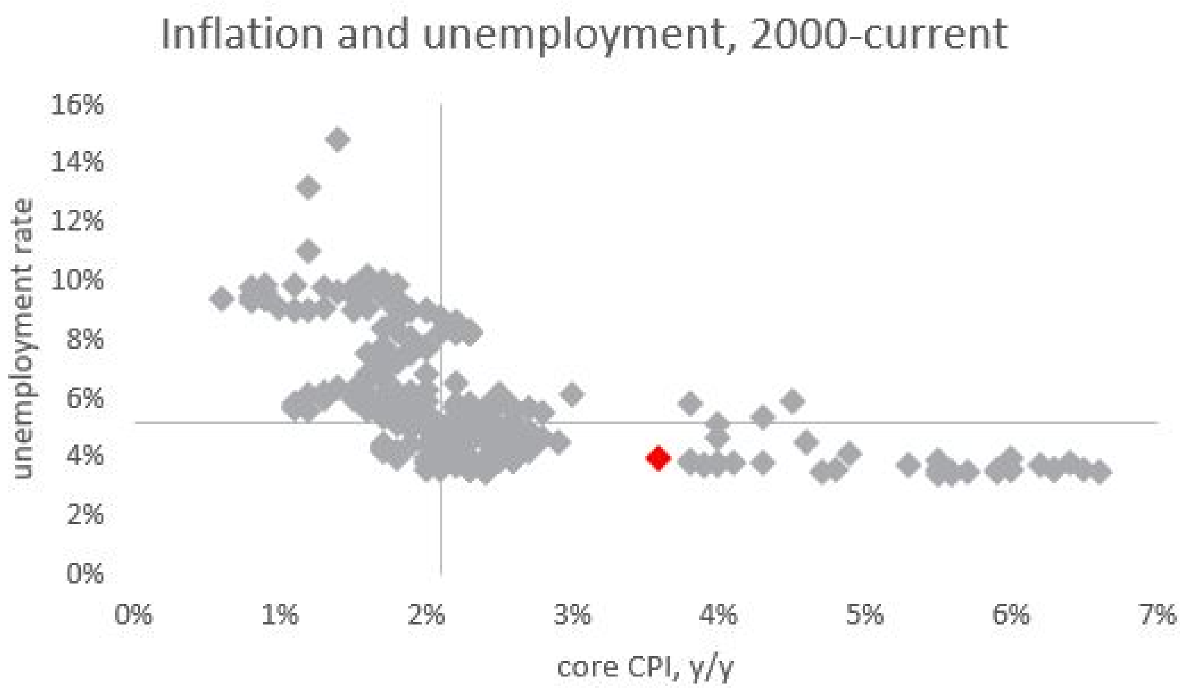
"Stagflation" first entered the macroeconomic lexicon in the early 1970s. The term describes a situation in which economic growth slows, unemployment rises, and yet inflation remains high or even accelerates. It’s becoming increasingly popular of late. Google Trends reports that US searches for “stagflation” peaked in the second half of April – at nearly 100 per week, a result similar to what we've seen in the Bloomberg News Trends data. Signs of sticky inflation and a slowdown in US growth of late have been driving this meme.

Setting aside for a moment what is actually happening in the US economy, we think labelling the environment stagflation is probably over dramatizing things. The current situation is nothing like the 1970s. Much of the debate revolves around what one means by stagflation – is it merely semantics, and does it matter? At the May 1 post-FOMC meeting press conference, Federal Reserve Chair Powell was asked if stagflation risk was a concern. His reply: “Right now we have 3 percent growth, which is, you know, pretty solid growth I would say, by any measure, and we have inflation running under 3 percent. So, I don’t—I don’t really understand where that’s coming from. … I don’t see the ‘stag’ or the ‘-flation,’ actually.”

The first chart below shows every monthly combination of annual core CPI inflation and the national unemployment rate since 1970. The second does the same since 2000. We draw horizontal and vertical axes to intersect at the median inflation (y-axis) and unemployment rate (x-axis) of each. The red dot indicates as of April 2024: 3.6% core inflation and a 3.9% unemployment rate, well outside the northeast quadrants of both graphs. Stagflation really doesn't seem appropriate to describe the current environment. What about going forward?

Historical Evidence



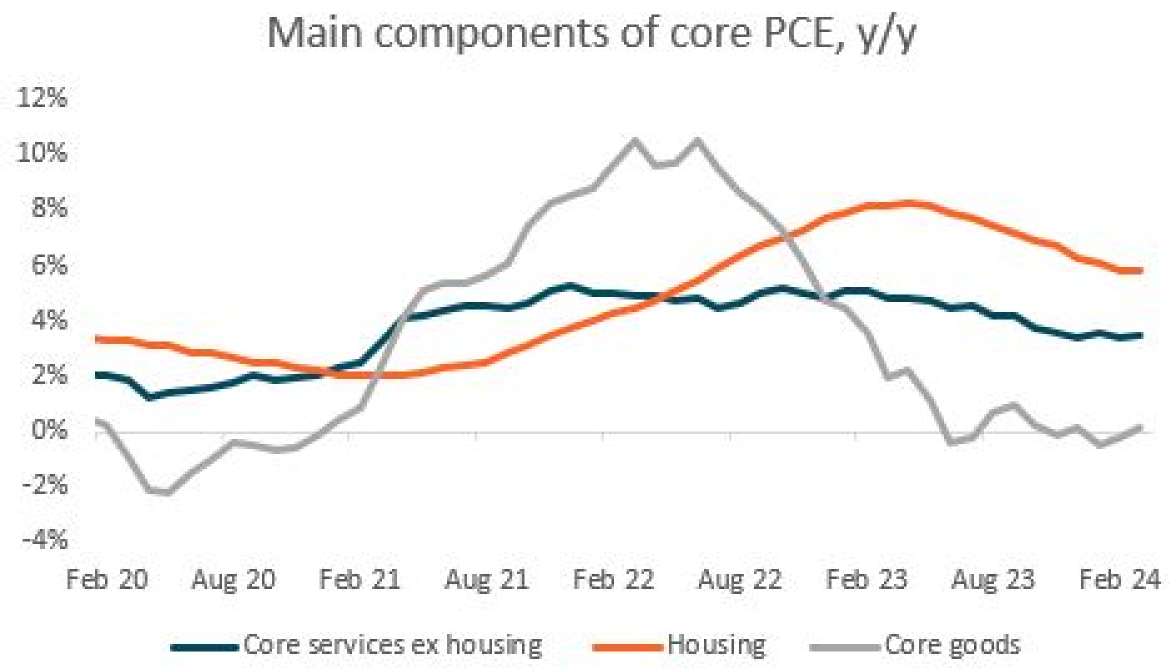


Source: BNY Mellon Markets, Bureau of Labor Statistics, Bloomberg

We should point out that the annual rate of core CPI inflation has fallen in all but three of the 20 past months, since September 2022, when it peaked at 6.6%. It was 3.6% this April. The evolution of core PCE has been even better, it has fallen every month since January 2023, although its progress has slowed in recent months. We find it difficult to describe 2.8% core PCE inflation (as of March) – less than one percent above the Fed's long-term target – as a pace of "-flation" that would meet the traditional definition of stagflation.

Still, there have been legitimate questions of how long inflation will take to return to 2%, or if it will. Services inflation remains troublingly sticky and has been heavy on the Fed's mind. With the PCE deflator for core services inflation ex housing still well above 3% (currently 3.5%), there is a long way to go. Powell pointed out recently that this category doesn't have to actually fall to 2%, but that implies the other two components of core PCE must stay close to zero (core goods inflation) or continue declining (housing inflation). The latter is key and has been slowly moderating. Home rental prices – from which the housing component of PCE is derived – are declining nationally and should increasingly be reflected in the index.

Yes, Inflation Is Sticky, But Progress Is There



Source: BNY Mellon Markets, Bureau of Labor Statistics, Bloomberg

Inflation it is declining, although much more slowly that it did, say, one year ago. If it were to stall at current levels for some time, necessitating higher policy rates for longer, it may take time to go lower. But Fed policy – which in our view remains restrictive – should work to lower prices over time. Even if progress has been slower than we had foreseen at the start of the year, we don't think the current inflation outlook is in line with any notion of stagflation.

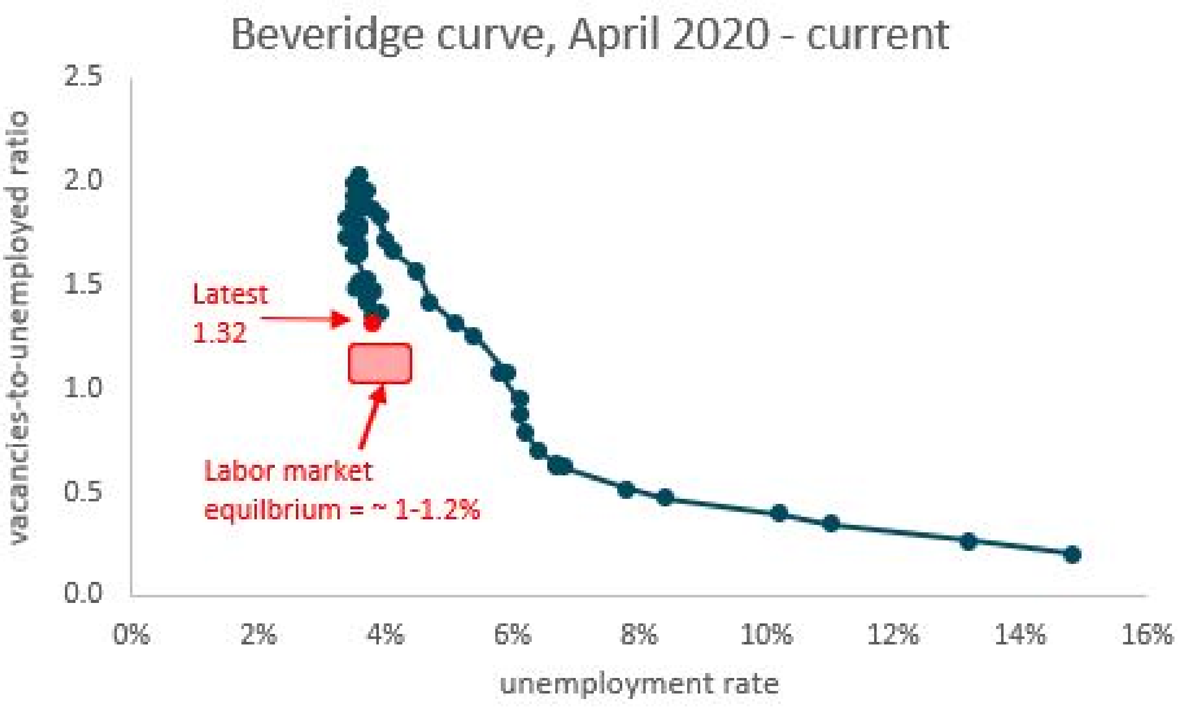
What about the growth side? The "stag" doesn't seem to be upon us either, although the economy is slowing, much in line with the ways we have expected. Don't forget, the US posted 4.9% and 3.4% growth in Q3 and Q2 of last year, respectively. The slowdown to a 1.6% pace in the first quarter of this year was a surprise, but as we pointed out when it was released, private domestic demand remains elevated, at 3.1% (real final sales to domestic purchasers), well in line with the four of the previous five quarters. Real trend growth is around 2%, to round most estimates to the closest integer.

The US labor market has still been running hot, although we have begun to see concrete signs of slowing in labor demand. This is entirely consistent with policy rates having been so high for so long – don't forget the Fed has held the funds rate at 5.25-5.50% since July of last year. It has taken this long for credit conditions to tighten sufficiently to impact loan growth. Slower loan growth typically leads to slower capex, hence lower labor demand, and ultimately to some softening of the labor market, taking the edge off services prices.

Job openings have been generally declining, while unemployment (those people who would theoretically look to fill those openings) has been inching up over time. The vacancy-to-unemployed ratio is now down to 1.32, getting close to the 1.0-1.2 ratio that we presume to represent labor market equilibrium. This is not a rapid deterioration of a labor market, in our view, rather a cooling off a still-slightly-hot one.

We don't think we are seeing stagflation; neither the "stag" nor the "-flation" appear present. What we are seeing is indeed, in our opinion, an economy that is moving slowly to equilibrium – in the respects of both aggregate demand and prices.

Moving Towards Labor Market Balance

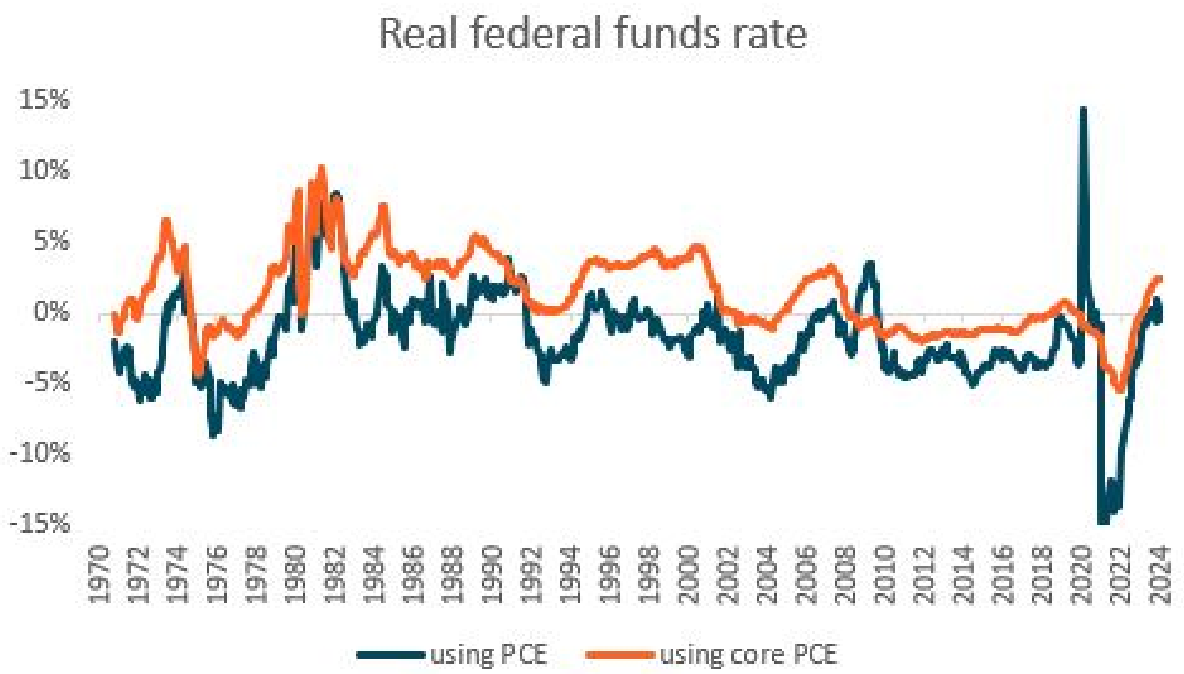


Source: BNY Mellon Markets, Bureau of Labor Statistics, Bloomberg

Whether Fed policy is indeed sufficiently restrictive has been a subject in market chatter recently, as well as in Fedspeak. As Minneapolis Fed President Kashkari argued, [The data] suggests to me that the current stance of monetary policy…may not be as tight as we would have assumed given the low neutral rate environment that existed before the pandemic." Powell disagrees: "…I do think the evidence shows … pretty clearly that policy is restrictive and is weighing on demand." We agree with Powell's view, as argued above.

In real terms, the policy rate is at 2.5%, if we use the Fed's preferred measure of inflation (core PCE). That makes it the highest real funds rate since 2007, on the eve of the Global Financial Crisis, when it touched 3.5%. We think that over time, this is restrictive enough for policy to continue to work to bring the economy into balance – certainly not stagflation.

Are Real Rates High Enough?



Source: BNY Mellon Markets, Bureau of Economic Analysis, Bloomberg

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Please direct questions or comments to: iFlow@BNYMellon.com

John Velis

AMERICAS MACRO STRATEGIST

CONTACT JOHN