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Macroeconomic Update

Recession Risks Mount with the Fed Determined to Crush Inflation

A Fed-induced downturn will be required to bring inflation down to target.

With the labor market overheated and inflation considerably above the Federal Reserve's (Fed) target, we have entered an uncomfortable regime where good news is bad news, and the "Fed put" is deeply out of the money. For the first time in many years, the Fed is aggressively tightening financial conditions in an effort to slow the economy, keep inflation expectations in check, and bring inflation down to the 2 percent target.

The Fed's crusade to crush inflation is reverberating around the world, as the strengthening dollar is boosting inflation and inflation expectations in other countries, forcing central banks to tighten policy abruptly to avoid an erosion of their own credibility. The tightening of global financial conditions will restrain growth, which is also being hampered by supply-side constraints: the U.S. unemployment rate has fallen to just 3.6 percent, commodity markets have been roiled by Russia's war in Ukraine, and the Chinese economy has been hobbled by renewed COVID-19 lockdowns and property sector woes.

Recession risks have clearly risen, with the U.S. monthly real gross domestic product (GDP) proxy having declined at an annual rate of 1.8 percent from October 2021 through May 2022—an unusual turn of events outside of downturns. Most available employment data remain strong, contradicting the recession narrative, but the pace of improvement in the labor market has slowed markedly since last fall. This indicates that the labor market has already started to cool even before the full impact of tighter financial conditions has been felt. High-frequency indicators and news reports point to a further slowdown in the job market in coming months.

Inflation is a lagging indicator and continues to run far above the Fed's target. While commodity prices and other leading indicators of inflation have cooled in recent months, the all-important headline consumer price index (CPI) number sits at a cycle high of 9.1 percent year over year as of June. Our analysis indicates that a Fed-induced downturn will be required to bring inflation down to target.

By Brian Smedley, Maria Giraldo, and Matt Bush

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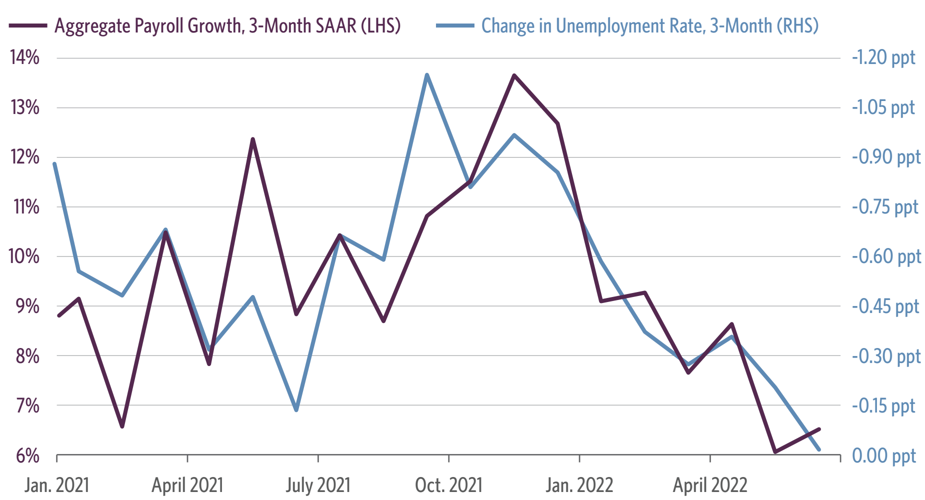
The Pace of Labor Market Gains is Cooling Rapidly



Source: : Guggenheim Investments, Haver Analytics, BLS. Data as of 6.30.2022.
Note: Aggregate payrolls reflects total employment, hours worked per employee and average hourly earnings.

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