

Research @ Citi Podcast, Episode 4: Inflation, Jobs, and the Path to U.S. Rate Cuts

Host: Lucy Baldwin, Global Head of Citi Research

Guest: Andrew Hollenhorst, U.S. Chief Economist, Citi Research

Transcript:

Lucy Baldwin (00:00)

Welcome to the Research @ Citi Podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe.

I'm delighted today to be joined by Andrew Hollenhorst, our chief U.S. economist. And today, we're going to have a broad conversation about all things related to the U.S. economy: inflation, growth, policy rates, and obviously where the future is going.

So, Andrew, maybe you can start and kick us off with a bit of scene-setting here. Markets obviously started the year pricing in quite a lot of rate cuts, at one point the market was pricing in six to seven rate cuts this year. And we've now kind of come full circle back to basically not really pricing in very much at all, maybe just that one rate cut this year, and right at the back end of the year, probably out in around December time. You yourself have shifted your base case of that first cut that you've been expecting to see, from July to September. Tell us a little bit more about what gets you there, what the risks are. And also, I think it's probably worth saying that now we've just come out of a recent data point where most people now in the FOMC just looking themselves for that one rate cut this year. And indeed, I think there's four people now suggesting in the FOMC, there's going to be no rates at all cut this year, looking at the dots.

Andrew Hollenhorst (01:31)

That's right, Lucy. A lot of disagreement across the committee right now about when to get started on these rate cuts. You're right on the markets and the data over the course of this year, it's just really whipsawed back and forth. And the starting point for this was late last year, the Fed was looking at a set of data where job growth was trending slower, where core PCE inflation over a six-month period was running at 2%, so at least for those six months at the end of 2023, they were kind of at their 2% target. And there was an expectation in the market that maybe that would be enough for the Fed to start cutting, and that's when all those rate cuts got priced in. Then we saw in the first quarter just a series of upside surprises to inflation. And, of course, that's been the story through so much of this post-Covid period. And those rate cut expectations had to be taken out by the market, had to be taken out by Fed officials. And you saw Fed officials moving away from rhetoric about approaching rate cuts and back towards this kind of higher-for-longer rhetoric. The idea that policy rates might just have to stay higher for a longer period of time. A lot of volatility in the data but we do think there's a trend here, and we think that trend is towards a loosening in labor markets and towards softer inflation. And that's what gets us to the September rate cut.

If I just pull out two trends in the data, one is what we're seeing in the labor market, and the unemployment rate is the key indicator for us there. It bottomed at about 3.5%. It's come up to 4.0% now. So still a low level of the unemployment rate but steadily coming higher. Inflation very, very volatile, but significantly lower than where it was running last year. So, we don't think that it's running at an underlying 2% pace — that's the Fed's target — it looks to us like maybe it's running closer to 3% than 2%. But still just the fact that that slowed down, and we should see that continuing in upcoming inflation readings. Now, one final point, if we

see a sharper slowing in the labor market, if we see that unemployment rate rise faster than expected — and in our forecast, we think we might see some of that — that would be even more reason for the Fed to start those rate cuts. But at least on the trajectory that we're running at now, it looks like they'll be ready to cut rates in September.

Lucy Baldwin (03:57)

Okay. Now, that makes sense. And just to pick up on this inflation target, Andrew, this 2% target, how seriously is the Fed taking that target now and how much flexibility do you feel they've really got to cut if inflation doesn't return back to that 2%?

Andrew Hollenhorst (04:13)

Well, that's the big question, and it's a difficult question because the Fed now is in a scenario where they really have to trade off the risks to the employment side of their mandate, trying to keep full employment, and the inflation side of the mandate where we're still running above target inflation. I think Fed officials, of course, have to take this seriously and have to indicate that they're going to get back to 2% inflation at some point. That's important for Fed credibility. That's important for keeping inflation expectations anchored. On the other hand, they have to ask themselves, how many people should be put out of work to move inflation from 3% to 2%. And this is what people sometimes call the “last mile problem” with inflation, where this final one percentage point of getting inflation back to target could be quite costly in terms of the employment cost. How slow is slow enough? How close is close enough? Like I was saying, a lot of indicators right now looking like more like 3% underlying inflation. If we can see some of those indicators look more like two-and-a-half percent inflation, it's not 2%, but it's probably close enough to give Fed officials confidence that they can start moving rates lower.

Lucy Baldwin (05:25)

That makes sense. And when you think about the inflation problem, if you like, why is it you think that policymakers, markets, economists — why has everybody consistently underestimated inflation this time around?

Andrew Hollenhorst (05:40)

So, there's an empirical side to this, and then I guess a theoretical framework side to this. And on the empirical side, the U.S. economy, developed market economies in general, ran stable, low inflation for a few decades. And when you've had that experience, it really seemed far-fetched in a way to think that we were going to have these much higher inflation rates and that they would be sustained for a significant period of time. So just the data itself hadn't shown that in many years so I think that was a surprise to many forecasters, to many policymakers. And on the theoretical side, an economy that had ample supply, and that wasn't just domestic supply, but it was also global supply, and you think about the last few decades, which was a story of globalization — integrating more low-cost producers into trade networks and supply chains — that really helped keep a lid on inflation, and that meant that the shocks that the U.S. economy was facing, developed market economies were facing, were demand-side shocks. So, everybody wants to go out and spend more and that's going to put upward pressure on prices. The Fed can respond to that by raising policy rates a bit, that's going to help bring that spending down, that's going to help damp those inflationary pressures. And that was the kind of well-controlled demand-shock-driven economy that I think we were living in for a few decades, and that changed with Covid.

And so making that theoretical jump to a framework where now it's not just the demand side that's determining things with a very ample supply side, now it's actually supply-side constraints that are interacting with that demand side. And what we've seen in the past when you had a supply-side constraint, let's say there was a certain commodity that was in short supply — we've had spikes in energy prices in recent years, for instance, and food prices — those things would come up and then they would come back down again because it wasn't a generalized supply constraint on the U.S. economy or on the global economy. And I think that's the framework that the Fed was operating in, a lot of forecasters were operating in, as we started to see prices rise in the U.S. What did we see? Things like semiconductors that were in short supply, chips that you needed to manufacture autos, and that meant that auto prices went higher. And so Fed officials were looking at this, and they used the term “temporary bottlenecks”. Because again, that's kind of what we had seen in previous years where these were temporary issues in supply chains. Ultimately, they'd work their ways out, their way out, of course. There's a lot of economic pressure to find ways to relieve these bottlenecks in supply chains. And that was the Fed view, that was the forecaster view. And that's where you get to the word “transitory”, which is a word, I think, a lot of central bankers think now that they wish they had used less. Because if these bottlenecks were going to be solved, it was going to be a transitory problem with higher inflation. And really, you just needed to wait for that to work its way through the economy. And that was the initial approach that policymakers took. The issue is that some of these supply-side constraints ended up being more significant and more persistent than Fed officials, other forecasters, had expected. And we even saw that in the labor market, and that's something that we're still dealing with in the U.S., where we had the supply of workers that went down during Covid, prime age participation came back up, but we still have areas where we don't have enough workers for the amount of demand that there is for those services. A lot of economies are experiencing this now.

We also had some unanchoring of inflation expectations, and this is something that's really sacrosanct for central bankers. They know that by keeping expectations of inflation set around 2%, well, what that is going to mean for individuals is wage increases of 3%, 4%, will mean that your wages are going up faster than prices. And firms will know that that's about where wages are going up, that's about where their competitors' prices are going up, so their prices will continue to go up by that amount. So you kind of have this virtuous situation where everyone expects around 2% inflation and you get around 2% inflation. Long-term inflation expectations still well anchored. Short-term inflation expectations, what we saw over the post-Covid period is people started to expect that higher inflation was not just going to be a transitory thing. It was actually going to last for a period of time. And so you saw wage growth that partly because supply of workers was limited, partly because people expected prices to rise. You saw these wage increases that were much higher than what we typically see. That drove more spending, and you can see how this just results in a continued cycle of higher prices. So, it started really in goods, but then it rotated through into services. And I think that's when it became more obvious to forecasters that this really wasn't going to be transitory. This was something that was going to take the power of monetary policy to raise interest rates, slow the economy, cool down inflation, and we're still in the midst of that process now.

Lucy Baldwin (11:07)

And I'm smiling as you say that, Andrew, because, I think even at the start of this year you had a number of economists coming out saying things like, “We in ‘Team Transitory’ can rightly claim victory.” And I think as you say, who's winning that battle between “Team Persistent” and “Team Transitory”, possibly the jury's still out and I'd love your thoughts on

that. When you take all of that inflation data that is clearly softening, albeit maybe taking longer to do so, and you add that to strong payrolls, does that mean soft landing's back on the agenda? And the reason I want your thoughts on that is because I know you still feel there's a real risk of a recession here.

Andrew Hollenhorst (11:47)

So, I think where Team Transitory is ultimately going to look at least qualitatively somewhat right, and maybe that's the most we can say, is on the goods side, and we were talking about used car prices before and car prices more generally with that chip shortage. We did see those supply chains normalize. We did see used car and new car prices come down from very high levels. And that disinflation is a lot of the reason that we got softer overall core inflation late last year. It was goods prices that had gone up a lot that then came down. We saw general commodity prices, energy prices that came down. So, on the goods side, there was a somewhat transitory nature of that. Now, still, I think Team Transitory was talking about a period of months over which this was going to happen. It ended up playing out over a period of years. But that did end up being at least qualitatively the right idea, that the supply side solved that problem, and we got lower goods prices.

What you're pointing to also though, Lucy, is where Team Persistent probably looks like they were very prescient in their forecast, which is services inflation. Services inflation tends to be a lot stickier. Car insurance, for example, that's a great example. It's been running up very, very strongly, and that's reflecting things like higher prices for cars and higher labor costs, wages, car prices. And that gets reflected in car insurance with a lag because we have insurance contracts that only update every year, maybe every two years, there's different regulation in different states. And that means that that inflation gets carried forward, and people say, well, that's a purely backward-looking thing, and that's true in some ways, but it's also a real cost that consumers are facing. And it goes back to this whole idea about, where is the general level of inflation in the economy. Even if this is rising, your car insurance is rising because of some lagged effect. Well, if I get the notice in the mail this week that tells me my car insurance is up 20% relative to where it was last year, that's a real cost I'm facing. I might go to my employer and want to have a wage that offsets that increase in cost. That would be a reasonable demand as a worker. And that's how you keep inflation running at higher levels in the economy. And that's part of why it's hard to bring down this inflation.

What's going to bring down service sector prices is less wage pressure. Less wage pressure comes with a looser labor market. So what the Fed would like to do, the way the Fed engineers a soft landing is loosen the labor market just enough to bring those inflationary pressures down. And as they're loosening the labor market just enough to bring those inflationary pressures down, that's when you start cutting rates because you don't want to keep rates at restrictive levels that push the labor market into more of a decline than it needs to be in to bring inflationary pressure down. That's the balancing act that the Fed is trying to figure out right now. And our concern regarding, are you going to get a sharper slowdown in the labor market, in the economy, the reason that we think that risk is still on the table is because the Fed has had to raise rates very significantly for this inflation issue, has had to leave rates there. Those rates have then stayed there higher for longer, and there is a cumulative effect of higher interest rates. The rates have more and more of an effect on the economy as they stay higher for longer. We already see a loosening in the labor market. The Fed starts cutting, maybe they're going to get it just right. Maybe we're going to get that soft landing. Unfortunately, the lesson from history is that usually once it becomes apparent that you should be cutting, these dynamics in the labor market are already established, and they keep going. There's something called the Sahm Rule, if the unemployment rate moves up by

half a percentage point, it tends to move up pretty rapidly after that, and we're up by about half a percentage point now, so definitely a risk that's still on the radar for us.

Lucy Baldwin (15:57)

Andrew, as you say, there's real conflict in some of the labor market data. What's the right read of that market? Do you look at the strong payrolls? Do you look at the softer household survey with unemployment rate rising to 4%? What's the right view of that labor market and how do we feel?

Andrew Hollenhorst (16:13)

I don't know that there's any one right view. What we try to do is look across all of the labor market data and then say, where is the balance of the labor market data? Payrolls, establishment survey employment, you go out and survey businesses. That's been extremely strong really for years now, a couple of years. And a year ago, we would have said, most other labor market agrees with that, the unemployment rate is coming down. So that looks like it's giving us a correct at least qualitative signal on the labor market that things are quite strong. Now we're kind of in the opposite scenario where those establishment survey payrolls numbers have been very strong. But in the household survey, you call people and ask them, "Are you working? Are you not working?" You see the unemployment rate that's steadily coming higher. We see a hiring rate that's down to levels that we haven't seen since ten years ago. So we're seeing these signs of softening in broad labor market indicators, not in the payrolls number. Immigration maybe is having something to do with why you're getting different readings from different reports. But on balance, we think that this is a labor market that's at least back to its pre-pandemic level of tightness, so we're kind of outside of this really overheated labor market. And probably a little bit looser than that, also loosening further. So again, why we keep that risk of more of a slowdown on the horizon.

Lucy Baldwin (17:28)

And that presumably, Andrew, is why you think the economy is going to slow in aggregate, is because of that coming through, right? Because many of your peers have thrown in the towel, so to speak, and said, "Actually, do you know what, this economy is just so much more resilient than I expect it to be, I'm going to just assume that this keeps going, I'm now not going to forecast a recession." Whereas you have, broadly, kept that call, which is out of consensus versus the rest of the Street.

Andrew Hollenhorst (17:57)

That's right. So the consensus for quite a while was that there would be a significant slowdown in the U.S. economy. It kept not happening. People had to keep pushing out those calls. What we've been waiting for is to see in the labor market, is that going to slow? And the reason the labor market is so important is because we really think that's the linchpin for the economy overall. People become worried about losing their job, if people lose their job, then that's when spending really slows down. So that can really drive a broader slowing in the economy if you have a weakening labor market. Again, what we're seeing in the labor market data now is telling us that we may be approaching that point where you have more of a nonlinear slowdown in the economy.

Lucy Baldwin (18:38)

Got to wrap things up a little bit by asking you, when you think about that potential for 30-year mortgage rates to go above 7%, can the U.S. economy cope with that? And then linked to that somewhat, how does the U.S. fiscal sustainability look to you? That comes up in a lot

of conversations. And does the Fed look at this when they're thinking about policy and planning? Does that get resolved any time soon?

Andrew Hollenhorst (19:05)

Yeah, I think you're tying together a lot of important points here, which is the idea that we can see somewhat higher interest rates in the U.S. if fiscal deficits stay high. And the way those higher interest rates would flow through to the rest of the economy is in higher medium- and longer-term yields, which would then show up in higher mortgage rates, and that would be an issue for the housing market. We've seen mortgage rates move higher but this was in an environment where there was tremendous fiscal stimulus coming into the economy. This was in an environment where there were excess savings from prior fiscal stimulus. So, that really helped insulate the economy to higher mortgage rates. If fiscal spending, if uncontrolled deficits, lead interest rates to move higher again in the long end and you get higher mortgage rates, that would further slow the housing sector. But it looks like we've gotten to a point where affordability has just become an issue, and the affordability is going to be driven by where is the mortgage rate? Where is the price? Both of those are higher now. More fiscal spending at the end of the day is going to put more upward pressure on interest rates. That could be an issue for housing and the broader economy. In terms of the Fed, this really creates an interesting conundrum for the Fed because the Fed is meant to let fiscal policy operate on a separate track and really tries to stay out of it from an institutional perspective. On the other hand, if what we're saying is looser fiscal policy is going to lead to higher interest rates, the Fed needs to respond to that because they know if interest rates move higher, that's going to slow down the economy. They're trying to achieve full employment and balance that with their price stability mandate. So that could mean more dovish Fed policy. So, a really complicated policy mix that fed officials have to deal with, but technically, they're running on different tracks.

Lucy Baldwin (21:00)

Andrew, that's amazing. Thank you so much for a super insightful whistle-stop tour as to what we see as next up for interest rates, inflation, the Fed, and, of course, the U.S. economy overall. Look forward to having you again on this podcast, Andrew.

Andrew Hollenhorst (21:16)

Thanks, Lucy. My pleasure.

Lucy Baldwin (21:20)

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