Establishing a Landing Scenario: Hard, Soft or No Landing

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No Expectations of Rate Cut this Year

The Federal Open Market Committee (FOMC) released its summary of economic projections at the conclusion of its recent two-day meeting held on June 13–14, 2023. The projections included possible outcomes for real gross domestic product (GDP) growth, the unemployment rate, PCE inflation and core PCE inflation for each year from 2023 to 2025 and over the longer run while also comparing it with the projections made in March, 2023 (Fig.1).

Fig.1

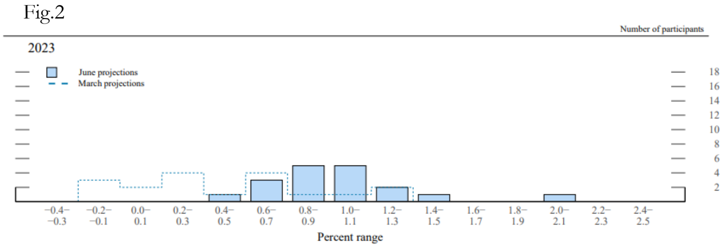
Percent

Variable	Median[1]				Central Tendency[2]				Range[3]			
	2023	2024	2025	Longer run	2023	2024	2025	Longer run	2023	2024	2025	Longer run
Change in real GDP	1.0	1.1	1.8	1.8	0.7–1.2	0.9–1.5	1.6–2.0	1.7–2.0	0.5–2.0	0.5–2.2	1.5–2.2	1.6–2.5
March projection	0.4	1.2	1.9	1.8	0.0–0.8	1.0–1.5	1.7–2.1	1.7–2.0	-0.2–1.3	0.3–2.0	1.5–2.2	1.6–2.5
Unemployment rate	4.1	4.5	4.5	4.0	4.0–4.3	4.3–4.6	4.3–4.6	3.8–4.3	3.9–4.5	4.0–5.0	3.8–4.9	3.5–4.4
March projection	4.5	4.6	4.6	4.0	4.0–4.7	4.3–4.9	4.3–4.8	3.8–4.3	3.9–4.8	4.0–5.2	3.8–4.9	3.5–4.7
PCE inflation	3.2	2.5	2.1	2.0	3.0–3.5	2.3–2.8	2.0–2.4	2.0	2.9–4.1	2.1–3.5	2.0–3.0	2.0
March projection	3.3	2.5	2.1	2.0	3.0–3.8	2.2–2.8	2.0–2.2	2.0	2.8–4.1	2.0–3.5	2.0–3.0	2.0
Core PCE inflation[4]	3.9	2.6	2.2		3.7–4.2	2.5–3.1	2.0–2.4		3.6–4.5	2.2–3.6	2.0–3.0	
March projection	3.6	2.6	2.1		3.5–3.9	2.3–2.8	2.0–2.2		3.5–4.1	2.1–3.1	2.0–3.0	
Memo: Projected appropriate policy path												
Federal funds rate	5.6	4.6	3.4	2.5	5.4–5.6	4.4–5.1	2.9–4.1	2.5–2.8	5.1–6.1	3.6–5.9	2.4–5.6	2.4–3.6
March projection	5.1	4.3	3.1	2.5	5.1–5.6	3.9–5.1	2.9–3.9	2.4–2.6	4.9–5.9	3.4–5.6	2.4–5.6	2.3–3.6

Source: Summary of Economic Projections, Federal Reserve

The current economic projections made for 2023 is different and striking compared to the projections made in March as real GDP growth was then projected at 0.4 per-cent while now it is projected to increase at 1 per-cent signalling higher real GDP growth (Fig.2).

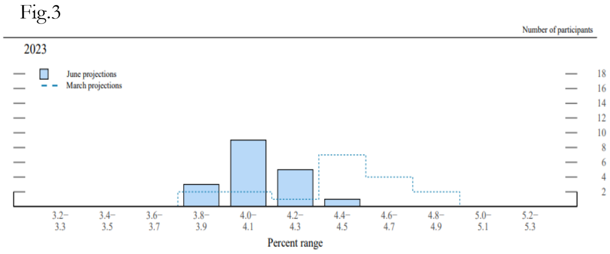
Fig.2



Source: Summary of Economic Projections, Federal Reserve

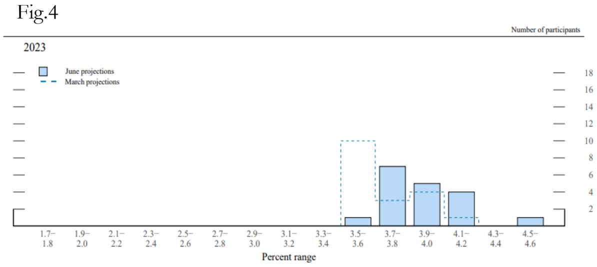
Owing to this high real GDP growth unemployment has been forecasted downward at 4.1 per-cent, down from 4.5 per-cent projected earlier (Fig.3) while core PCE inflation forecasted upwards at 3.9 per-cent, up from earlier 3.6 per-cent (Fig.4).

Fig.3



Source: Summary of Economic Projections, Federal Reserve

Fig.4

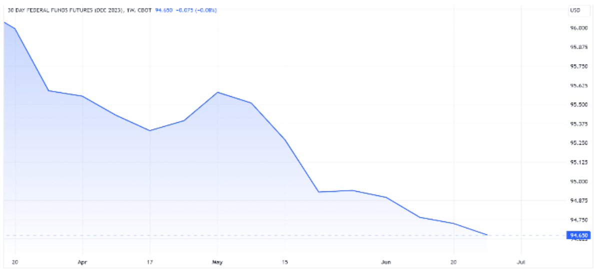


Source: Summary of Economic Projections, Federal Reserve

Taking into consideration higher real GDP growth coupled with lower unemployment presents a case for a more resilient economy hence it is expected that core inflation could be sticky for a while which leads a higher forecasted Federal funds rate, up from 5.1 per-cent to 5.6 per-cent for 2023, a 50 bps points increase compared to projection made in March.

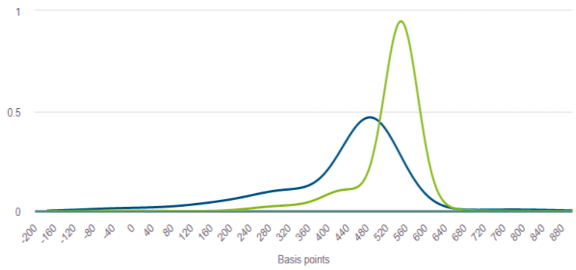
Considering the forecasted range of Federal funds rate being shifted upwards to 5.1-6.1 per-cent from earlier 4.9-5.9 per-cent indicates that the market participants are not expecting any rate cuts this year and are considering the current rate as the floor. Looking at the FED funds futures curve for December confirms this notion, the futures price has been coming down and the current implied rate is around 5.35 per-cent (Fig.5) while the distribution of the average SOFR for December has shifted rightwards from a range of 400-500 bps in April to a current range of 500-600 bps along with a greater kurtosis (Fig.6).

Fig.5



Source: CME Group, Interest rates

Fig.6



Source: Federal Reserve Bank of Atlanta

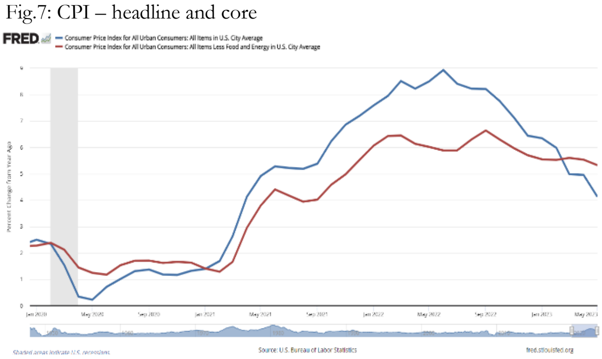
Federal Reserve's Dual Mandate

The Federal Reserve is mandated by the Federal Reserve Act to effectively focus on the dual mandate of 'price stablility' and 'maximum employment'. In order to achive this dual mandate the The Federal Open Market Committee (FOMC) has observed that an inflation rate of 2 per-cent over the longer run, as measured by the annual change in the PCE (Personal Consumption Expenditure) price index, is the most consistent measure to keep up with the dual mandate.

The United States witnessed unexpectedly high inflation since late 2021 as the economy began to reopen following the COVID-19 lockdowns. The surge in prices has had drivers from both the demand and supply side: (1) Supply chain disruption (2) Shift in demand towards goods and away from services (3) Shock to labor supply shortage due to tight labor market (4) Supply shocks to energy and food because of the Russian invasion of Ukraine.

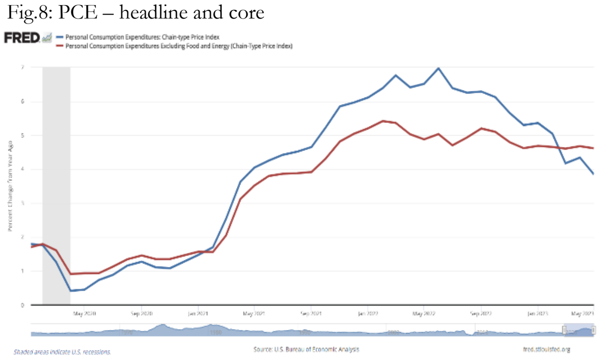
Both the Consumer Price Index (CPI) and Personal Consumption Expenditure (PCE) price index - headline and core – were making new high till mid 2022 and were significantly above target. Only recently did it start moderating but it is still expected to remain above target through end of this year.

Fig.7: CPI – headline and core



Source: FRED

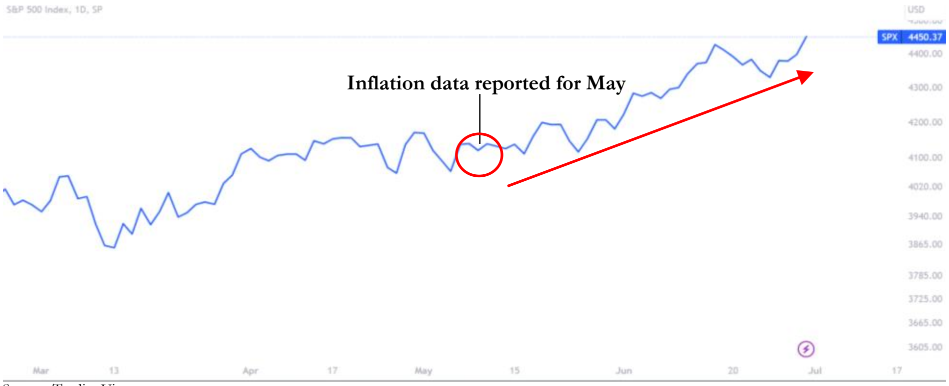
Fig.8: PCE – headline and core



Source: FRED

The news agencies presented the lastest inflation reading as the smallest annual increase in more than two years which led to a rally in the U.S. stock market (Fig.9) but the market seem to disregard the factor that core inflation did not fall much and still remains elevated.

Fig.9



Source: TradingView

The reduction in energy prices was the primary factor that pushed the headline inflation down to 4 per-cent. Except for energy the price change for all other items stayed mostly above the target of 2 per-cent, thus keeping the core inflation stay elevated at 5.3 per-cent (Fig.10).

Fig.10

	Seasonally adjusted changes from preceding month							Un-adjusted 12-mos. ended May 2023
	Nov. 2022	Dec. 2022	Jan. 2023	Feb. 2023	Mar. 2023	Apr. 2023	May 2023	
All items	0.2	0.1	0.5	0.4	0.1	0.4	0.1	4.0
Food	0.6	0.4	0.5	0.4	0.0	0.0	0.2	6.7
Food at home	0.6	0.5	0.4	0.3	-0.3	-0.2	0.1	5.8
Food away from home[1]	0.5	0.4	0.6	0.6	0.6	0.4	0.5	8.3
Energy	-1.4	-3.1	2.0	-0.6	-3.5	0.6	-3.6	-11.7
Energy commodities	-2.1	-7.2	1.9	0.5	-4.6	2.7	-5.6	-20.4
Gasoline (all types)	-2.3	-7.0	2.4	1.0	-4.6	3.0	-5.6	-19.7
Fuel oil[1]	1.7	-16.6	-1.2	-7.9	-4.0	-4.5	-7.7	-37.0
Energy services	-0.6	1.9	2.1	-1.7	-2.3	-1.7	-1.4	1.6
Electricity	0.5	1.3	0.5	0.5	-0.7	-0.7	-1.0	5.9
Utility (piped) gas service	-3.4	3.5	6.7	-8.0	-7.1	-4.9	-2.6	-11.0
All items less food and energy	0.3	0.4	0.4	0.5	0.4	0.4	0.4	5.3
Commodities less food and energy commodities	-0.2	-0.1	0.1	0.0	0.2	0.6	0.6	2.0
New vehicles	0.5	0.6	0.2	0.2	0.4	-0.2	-0.1	4.7
Used cars and trucks	-2.0	-2.0	-1.9	-2.8	-0.9	4.4	4.4	-4.2
Apparel	0.1	0.2	0.8	0.8	0.3	0.3	0.3	3.5
Medical care commodities[1]	0.2	0.1	1.1	0.1	0.6	0.5	0.6	4.4
Services less energy services	0.5	0.6	0.5	0.6	0.4	0.4	0.4	6.6
Shelter	0.6	0.8	0.7	0.8	0.6	0.4	0.6	8.0
Transportation services	0.3	0.6	0.9	1.1	1.4	-0.2	0.8	10.2
Medical care services	-0.5	0.3	-0.7	-0.7	-0.5	-0.1	-0.1	-0.1

Source: Bureau of Labor Statistics

The Chairman of the Federal Reserve, Jerome Powell, has recently stated that they are considering three checklists while monitoring target inflation – goods, housing and, services ex-housing. It is observed that for goods, the price change has moderated around the target level but for housing the price change still remains well above the target level driven by higher rent and housing prices and it is similar for services ex-housing where it is primarlity being driven by high wage inflation.

It can thus be concluded that there is no progress seen towards moderation of core inflation and risks to inflation are still on the upside. The Federal Reserve may see this as an indication of having to keep a tight monetary policy.

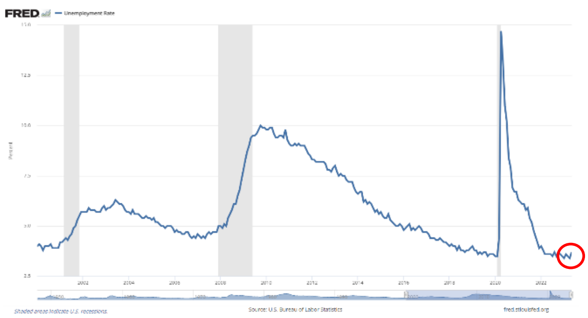
The United States labor market remains strong after adding around 1.65 million non-farm payroll jobs in 2023. After losing around 8.85 million jobs in 2020 the labor market cumulatively added 11.6 million non-farm payroll jobs from January 2021 to May 2023 with May being the 28th consecutive monthly gain in non-farm payroll jobs.

The COVID-19 pandemic brought in disruptions in the labor market, lockdowns and sick workers led to labor shortages that were amplified by other factors, including early retirements, less immigration, and lack of childcare, which reduced the economy's productive capacity.

As the economy reopened, the demand for workers persistently exceeded the number of unemployed people looking for work.The current labor market situation has been perhaps the most worker-friendly climate in decades, as workers have the ability to sort through near-record levels of job openings, given the labor shortages. Tight labor market which continues to put upward pressure on wage inflation.

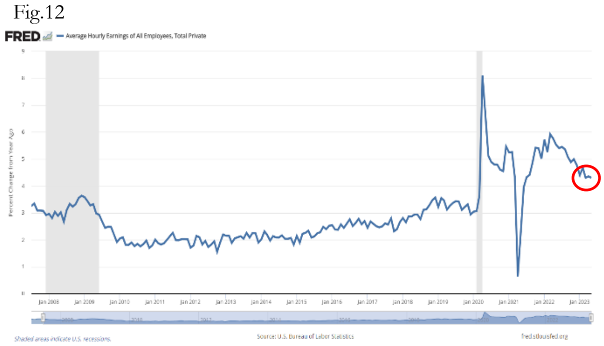
Currently the unemployment rate stands at 3.7 per-cent which is around the lower level of it's historical range (Fig.11) while the change in average hourly earnings of the private sector (y-o-y) stands around 4.30 per-cent which is around the higher level of it's historical range (Fig.12)

Fig.11



Source: FRED

Fig.12



Source: FRED

The policymakers have taken significant steps to cool the economy and ease inflation but tight labor market and elevated wage growth have continue to put upward pressure on both goods and services price inflation and may even create a risk of a wage-price sprial. Thus, it may induce the Federal Reserve to continue to keep the monetary policy tight.

Scenario Analysis

There are three possible landing scenarios based on future real GDP growth and inflation rate, its influence on the Federal Reserve's dual mandate of "price stability" and "full employment" and consequent policy rate decision taken by the Federal Reserve.

Scenario	Upcoming Economic Data		Fed's Dual Mandate		Policy Rate Decision
	Real GDP growth	Inflation rate	Full Employment	Price Stability	
No Landing	Higher	Lower	Achieved	Achieved	No rate cut*
Soft Landing	Lower	Higher	Partially achieved	Not achieved	Some rate hike**
Hard Landing	Lower	Lower	Not achieved	Achieved	Rate cut

*A no-landing scenario may create a new "neutral rate" of 5.25 per-cent from the current 2.5 per-cent as there will be no motive for the Federal Reserve to cut interest rate in a high growth environment just to get inflation back again. This may lead to a higher discount rate that the equity market will have to factor in.

**The Federal Reserve may go for some more rate hikes as it is currently more focused on the price stability.

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