KPMG Economics

Lost in Translation
The Federal Reserve vs. Financial Markets

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The 2003 hit movie, **Lost in Translation**, traces the frustration of an aging actor, Bill Murray. He is suffering a midlife crisis, while shooting a commercial for a Japanese whiskey in Japan. His isolation is compounded by his inability to understand the culture or the language.

His translator only makes matters worse. A soliloquy of guidance by his Japanese director is reduced to a few words. That leaves him baffled, not knowing which way to turn his head or how to deliver his line.

The metaphor seemed apt, given the dissonance between what the Federal Reserve says it is trying to accomplish and what financial markets are hearing. Credit conditions have eased significantly in recent months and threaten to reflate a cooling economy.

The Fed's lead translator, Chairman Jay Powell, failed to push back against market optimism on rate cuts. That spurred the market rally and further eased credit conditions. To quote a friend, Stu Hoffman who is an economic advisor for a major bank, Powell waved a "red flag at a raging bull market."

The easing of credit conditions has already shown up as an acceleration in growth and a threat to inflation. Mortgage rates dropped significantly from their peak, which is pulling buyers off the sidelines and is likely to stem the drop in shelter costs, something the Fed is counting on to cool inflation.

The Institute for Supply Management (ISM)'s services index moved back into expansion territory in January, an area where the Fed remains most worried that inflation will persist. Some goods prices have already rebounded. Energy prices, used vehicle prices and raw construction materials prices are rising again.

Weak Start to 2023

Real GDP rose at a 2.9% pace in the fourth quarter and ended 2022 with annual growth of 2.1%. That is a sharp slowdown from the 5.9% pace of 2021 but still well above the economy's potential. Growth on a fourth-quarter-to-fourth-quarter basis, which better captures momentum in the economy, slowed to a 1% pace in 2022, after rising 5.7% in 2021.

Consumer spending slowed but did not collapse at the end of the year; housing slipped further into recession; investment was essentially flat; and inventories ballooned. Government spending surprised to the upside with infrastructure spending ramping up faster than expected. State and local governments offered tax holidays and rebates to blunt the blow of higher gas and food prices. The trade deficit narrowed, but for the wrong reasons. Imports plummeted faster than exports.

Real GDP growth is forecast to contract slightly in the first half. Consumer spending is expected to stall; housing is poised to slip further; businesses are pulling back; and inventories need to be liquidated. Government spending will be buoyed by the surge in Social Security payouts and ongoing strength in infrastructure. The trade deficit is expected to narrow with imports holding up better than exports due to the strong dollar.

The economy is poised to pick up in the second half. Lower inflation and prospective rate cuts in early 2024 are forecast to fuel those gains. By then, an easing of credit conditions will be appropriate. The risk is a showdown over the debt ceiling.

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Most notable is that labor markets, where demand and supply remain most out of alignment, further tightened in January. We added more than a half million paychecks during the month, nearly double the upwardly revised pace of December. The raw data shows a contraction but much less than usual for the month, as employers hoarded staff.

Low-wage industries were most affected in January. Leisure and hospitality accounted for nearly 30% of employment gains, while seasonal layoffs in the retail sector were the lowest since 1990.

The Fed's recent Beige Book documented the phenomenon. "Many firms hesitated to lay off employees even as demand for their goods and services slowed and planned to reduce headcount through attrition."

Wages continued to cool, but those shifts could be short-lived. The unemployment rate fell to 3.4%, matching the low of 1969. The country's largest employer announced a rise in entry-level pay from $12 to $14 per hour at the end of the month. Those increases tend to ripple up the wage strata and play a larger role in determining pricing in the service sector, the largest part of overall inflation.

Job openings soared above 11 million in late December, while the ratio of job openings to seekers jumped to 1.9, which could further stoke wage gains. A surge in openings at businesses with fewer than 250 workers drove the jump; firms with more than 5,000 workers reduced job postings.

This edition of *Economic Compass* takes a closer look at the breakdown in communication between the Fed and financial markets, how Powell muddied the waters and the impact those shifts are having on the outlook. The miscues underway are seeding stronger growth, which could trigger another bout of inflation. That is the very error the Fed is determined to avoid.

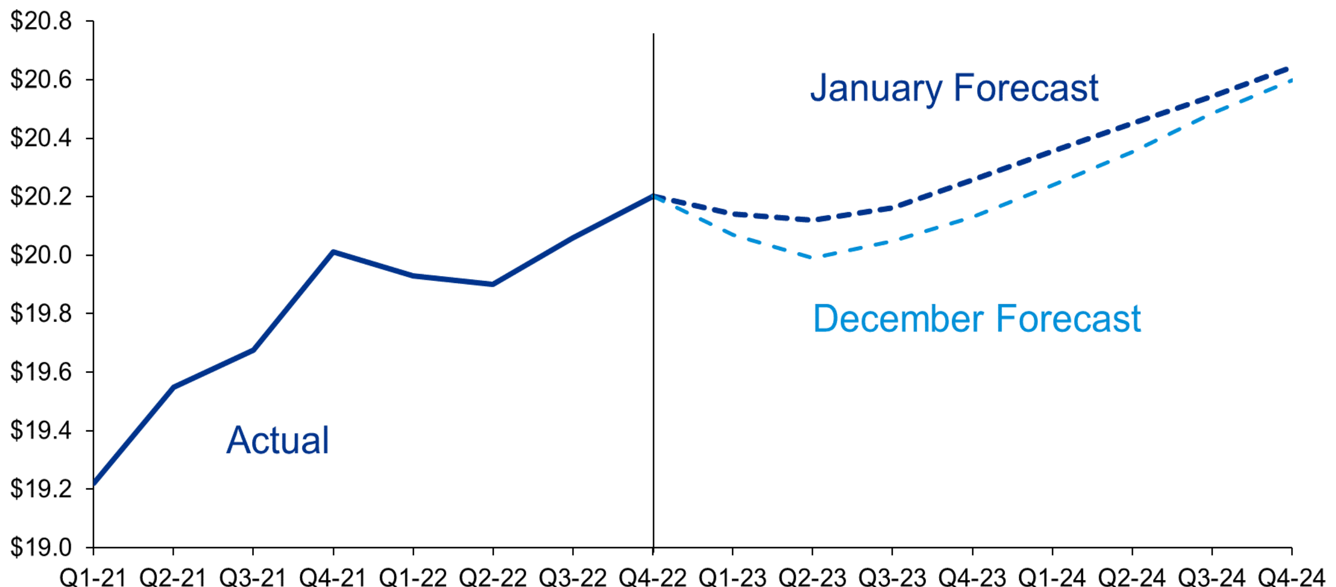
A recent blog post by researchers at the International Monetary Fund was more direct. It warned that central bankers may need to "push back against investor optimism...to ensure price stability."

Muddled Messaging

Powell stuck to the script at the press conference following the February meeting. He and his colleagues:

- Expect a "couple more" rate hikes, which is more than financial markets were expecting prior to the meeting.

Chart 1



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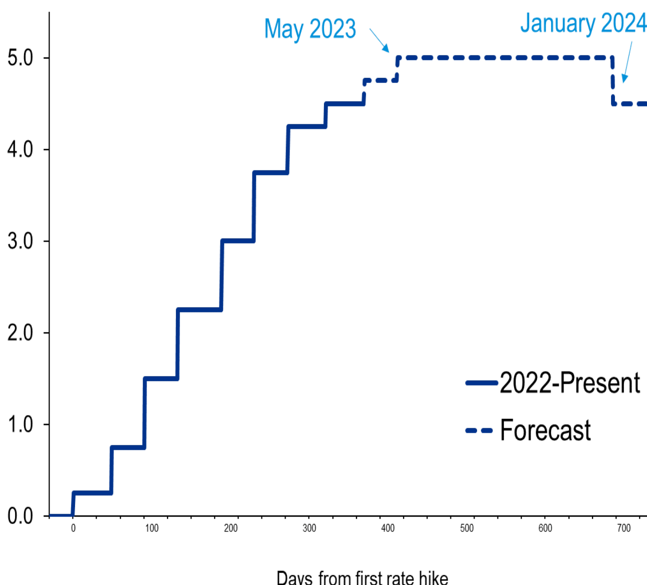
- Worry core services (excluding shelter) inflation will remain persistantly high, which is currently at 4%.
- Fear the risk of “doing too little” is greater than doing too much. The bias within the Fed is to overshoot rather than undershoot on hikes.

Powell failed to push back against credit market easing when asked about the challenge that recent easing posed to the forecast. He said it was not his job to tell financial markets what to forecast. Actually, it is.

The announcement effect of monetary policy is often much larger than the impact of actual movements in policy. We saw this when the Fed announced it would buy mortgage debt during the height of the subprime crisis in 2009. The mortgage market, which had seized, reopened before the Fed bought one single mortgage-backed security.

Powell said he was “gratified” by the “disinflation” or progress made on inflation. That was the signal for a cut in rates that markets yearned for. Lost in translation was the fact that progress on inflation does not equal victory over inflation.

Chart 2



A Milder Contraction

Chart 1 compares the current forecast with where we were last month. The recent credit market easing is buoying demand and will likely stem some of the progress the Fed made on inflation. The fed funds rate is now expected to hit 5.25% and stay there through year-end. The goal will be to force financial markets to capitulate and keep credit conditions tighter for longer. (See Chart 2.)

The economy is now forecast to contract modestly in the first half and rebound in the second half. Gains will be back loaded into the year, as financial markets are now expected to be more constrained for longer.

Consumer spending stalls but does not collapse, as affordability takes a toll on everything from vehicle purchases to big-ticket home furnishings. Rising financing costs are exacerbating the erosion in affordability. All-cash purchases of vehicles have picked up as wealthier buyers do not want to ante up for the additional interest expense, but the ranks of those who can do that are limited.

The collapse in home buying and building is another headwind. Home buying is the single largest trigger of additional spending; those shifts are working in reverse.

The January employment report likely exaggerated strength in the labor market. A recent survey by the National Association for Business Economics was more ominous. It showed that 20% of respondents expected their firm to cut employment over the next three months. The only periods to exceed that pace were during the height of the 2008-09 crisis and the worst of the losses of the pandemic. This is reinforced by high profile announcements of hiring freezes and layoffs.

Those who receive severance via extensions to their paychecks show up on payrolls and are not eligible for unemployment insurance until those payments stop. That is one of many reasons that recent layoff announcements have not shown up in the data.

Another is the surge in hiring by smaller, new businesses, which are making it easier for those who lost jobs to get re-employed. High-quality business formation – firms that intend to hire – is cooling from the red-hot pace we saw with the initial reopening but remains much higher than it was in the 2010s.

The wild card is the 8.7% increase in Social Security payments, which added an estimated $8.9 billion to incomes in January alone. If a recent business trip is any indicator, much of it was left in Las Vegas.

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Housing activity is expected to bottom out during the first half of the year. Mortgage applications have come off their lows but were still 40% behind year-ago levels in late January. Millennials are aging into their prime home-buying years and want to buy. The single-family home market was the first to enter a recession and will be the first to exit.

Home values are expected to hit a trough later than sales and construction. The housing affordability index was still at the lows of the mid-1980s in November.

Bids for homes on the market cooled as fewer homes sold above the asking price in January. We now expect the S&P CoreLogic Case-Shiller Home Price Index to fall 10% from peak to trough by year-end. Listings are picking up, but supplies remain constrained. Either values fall further to clear the market or the rebound in activity will be more muted.

The multifamily market is hit later but takes longer to recover. The pandemic pulled activity from 2020 into 2021, while builders scrambled to catch up. The backlog of projects in the pipeline hit 926,000 in December, slightly above the previous peak, which occurred in 1973.

Rents are expected to fall in response to a rise in vacancies and a surge in supply. Affordability has already suppressed churn in the market, while the migration patterns that drove the housing boom have started to ease. More college students are doubling up or working from their parents' home after graduation.

The surge in business formation during the pandemic exacerbated the hollowing out of urban centers and shift in economic activity to surrounding suburbs. New businesses were skewed toward services and tech, which followed worker migration.

Business investment is expected to contract at the start of the year. Core factory orders dropped at the end of 2022, while purchasing managers' indices slipped further into contraction territory in January. The exception will be electric vehicles and chip plants, both of which are benefiting from government incentives.

Commercial real estate is expected to move sideways after hitting a plateau in the fourth quarter. The work from home genie will not go back into its bottle; cap rates on office space spiked in the fourth quarter. Hotels are expected to do better.

Investment is expected to regain momentum in the second half. Companies plan to invest in labor-saving technologies. Productivity growth that is shared with workers enables higher wage growth without inflation.

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The greatest gains in productivity growth are when investments are made to bridge skills gaps rather than just replace labor for capital. This will be critical as firms balance what AI can accomplish and mistrust of it.

Inventories are forecast to drain after ballooning in late 2022. This will add to the contraction in manufacturing activity, which was already in the red relative to a year ago in December 2022. Those losses are expected to dissipate in the second half of the year.

The outliers are vehicle producers, which are still replenishing inventories. The problems are labor shortages, which remain acute. UAW negotiations are in June; workers now have an upper hand.

The **trade deficit** is forecast to narrow slightly. A slowdown in consumer spending and drawdown in inventories is expected to suppress imports, while stronger than previously expected growth abroad buoys exports.

Supply chains are reshuffling and further regionalizing. The Philippines and Vietnam are gaining much of what would have previously gone to China or is now leaving the country. Mexico is being sought out by investors, given the guarantees that are baked into the USMCA trade agreement.

Less is showing up as on-shoring to the U.S. The wild card is the reopening of China and what could be a stronger rebound in imports than is currently forecast.

Government spending is forecast to add to growth early in the year, as Social Security payments surge and infrastructure projects ramp up. Heated negotiations over next year's budget and the threat of a showdown over the the debt ceiling should curb spending in fiscal 2024.

Congress and the White House have begun negotiations, which is encouraging. Treasury is expected to continue servicing debt until this summer, but a fight to the brink of default can't be ruled out.

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State and local governments remain flush with cash following the pandemic-induced surge in home buying. Tax revenues soared along with pandemic aid. That showed up in rainy day funds, tax rebates and tax holidays, all of which should keep spending at the state and local governments from collapsing.

Risks. If financial markets fail to capitulate, credit conditions will further ease. That will stimulate growth when wages may be on the brink of accelerating again.

Add escalating geopolitical tensions with China, which could trigger a new round of supply-chain disruptions, and both growth and inflation could accelerate instead of cool. That is the exact opposite of what the Fed is attempting to accomplish. The 5.25% forecast on the terminal fed funds rate could be too low.

Bottom Line

Lost in Translation was about how two strangers could bridge their own sense of isolation in a foreign country, connect and communicate. It ended with one of the most iconic non verbal endings on film. Bill Murray caught up with his costar, Scarlett Johansson, after an awkward goodbye at the hotel. She had tears in her eyes. He embraced her, whispered in her ear and kissed her. He watched her walk away and got in his cab to the airport.

Much like Bill Murray's character, financial markets are suffering both a culture shock and the miscues of their translator, Chairman Powell. The irony is the more they ease credit conditions, the more the Fed will have to eventually raise rates. The Fed's next move beyond its current 5.25% target could now be up instead of down.

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Economic Forecast —February 2023

	2022	2023	2024	2022:3(A)	2022:4(A)	2023:1	2023:2	2023:3	2023:4	2024:1	2024:2	2024:3
National Outlook												
Chain Weight GDP[1]	2.1	0.7	1.6	3.2	2.9	-1.2	-0.4	0.8	1.9	1.9	1.9	1.8
Personal Consumption	2.8	1.1	1.2	2.3	2.1	0.2	0.3	1.0	1.3	1.1	1.4	1.5
Business Fixed Investment	3.6	0.3	1.6	6.2	0.7	-1.4	-1.6	-0.4	1.5	2.5	2.4	2.4
Residential Investment	-10.7	-17.3	5.0	-27.1	-26.8	-16.4	-16.0	-2.0	4.2	8.7	10.5	7.8
Inventory Investment (bil $ '12)	123	34	61	39	130	59	23	17	35	49	60	68
Net Exports (bil $ '12)	-1346	-1155	-1149	-1260	-1223	-1194	-1152	-1140	-1134	-1134	-1144	-1157
Exports	7.3	3.8	6.1	14.6	-1.3	-1.0	4.0	5.0	6.7	6.5	6.2	6.2
Imports	8.1	-2.4	4.1	-7.3	-4.6	-3.7	-1.7	2.1	4.1	4.5	5.5	5.7
Government Expenditures	-0.6	2.0	0.9	3.7	3.7	2.2	1.2	1.0	0.9	1.0	1.0	0.8
Federal	-2.5	2.6	0.3	3.7	6.2	4.8	0.2	0.2	0.0	0.5	0.5	0.3
State and Local	0.6	1.6	1.3	3.7	2.3	0.6	1.8	1.4	1.5	1.2	1.2	1.1
Final Sales	1.4	1.2	1.5	4.5	1.4	0.1	0.3	1.0	1.6	1.6	1.7	1.7
Inflation												
GDP Deflator	7.0	3.2	2.5	4.3	3.6	1.8	2.7	2.6	2.9	2.3	2.3	2.3
CPI	8.0	4.0	2.4	5.7	3.1	3.1	3.5	3.2	3.2	2.0	1.4	2.7
Core CPI	6.1	4.5	3.0	6.4	4.4	4.1	4.4	3.4	3.1	3.0	2.7	2.7
Special Indicators												
Corporate Profits[2]	11.5	-6.7	0.6	5.5	11.5	3.0	-0.3	-1.0	-6.7	1.0	-0.1	0.8
Disposable Personal Income	-6.4	2.8	3.3	1.0	3.3	5.5	1.3	3.0	3.5	4.4	3.5	2.5
Housing Starts (mil)	1.56	1.27	1.29	1.45	1.40	1.27	1.26	1.25	1.29	1.29	1.28	1.28
Civilian Unemployment Rate	3.6	3.9	4.5	3.5	3.6	3.4	3.7	4.1	4.3	4.4	4.5	4.6
Total Nonfarm Payrolls (thous)[3]	4876	708	-341	1145	785	1674	-206	-430	-330	-180	-92	-54
Vehicle Sales												
Automobile Sales (mil)	3.0	3.2	3.6	3.2	3.1	3.0	3.0	3.2	3.5	3.5	3.6	3.6
Domestic	2.2	2.2	2.4	2.3	2.3	2.1	2.1	2.2	2.3	2.3	2.3	2.4
Imports	0.9	1.0	1.3	0.9	0.8	0.9	0.9	1.0	1.2	1.2	1.3	1.2
LtTrucks (mil)	11.0	12.1	12.5	10.6	11.6	12.3	12.0	11.9	12.3	12.3	12.5	12.5
Domestic	8.6	9.7	10.0	8.2	9.0	9.9	9.7	9.5	9.8	9.9	10.0	10.0
Imports	2.4	2.4	2.5	2.4	2.6	2.4	2.3	2.4	2.5	2.4	2.5	2.5
Combined Auto/Lt Truck	14.1	15.3	16.1	13.8	14.7	15.3	15.0	15.1	15.8	15.8	16.1	16.1
Heavy Truck Sales	0.5	0.4	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.5	0.5
Total Vehicles (mil)	14.6	15.7	16.6	14.3	15.2	15.8	15.4	15.5	16.2	16.2	16.6	16.6
Interest Rate/Yields												
Federal Funds	1.7	4.9	3.8	2.2	3.7	4.5	5.0	5.1	5.1	4.7	3.9	3.4
10 Year Treasury Note	2.9	3.6	3.4	3.1	3.8	3.6	3.6	3.6	3.6	3.5	3.4	3.4
Corporate Bond BAA	5.1	5.7	5.5	5.4	6.0	5.6	5.8	5.7	5.7	5.6	5.5	5.5
Exchange Rates												
Dollar/Euro	1.05	1.09	1.12	1.01	1.02	1.07	1.08	1.09	1.11	1.12	1.12	1.12
Yen/Dollar	131.5	126.8	123.0	138.4	141.5	130.0	127.0	125.0	125.0	123.0	123.0	123.0

[1] in 2022, GDP was $20 trillion in chain-weighted 2012 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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