A Soft Landing Coming?

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Tight monetary policy has almost always been a primary culprit when the U.S. economy has fallen into a recession. That is because restrictive monetary policy is designed to reduce aggregate demand in the economy. Thus, when the Federal Reserve (Fed) began its monetary tightening in March of 2022, market observers began to contemplate the arrival of a recession at some point. Subsequent events had only deepened the expectation that a recession was almost inevitable.

The Fed tightened very quickly, consistently raising the federal fuds rate to its current level of 5.5%. At this level, policy is clearly in restrictive territory. Furthermore, quantitative tightening is proceeding as the Fed reduces the size of its balance sheet. Yet, the most anticipated recession in memory remains elusive. Real Gross Domestic Product (GDP) has remained positive, and early indications are that it accelerated in the second quarter. Perhaps of more importance, unemployment remains near record lows at 3.6%.

Very recently, a shift in the recession narrative has occurred. While the consensus view was that a recession was far more likely, most economists also allowed a small possibility that a recession could be avoided and that the economy could experience a soft landing. The recent shift in expectations is now granting a larger possibility that a soft landing can occur. That means that inflation could come down near target at the same time that employment remained strong, thus giving the Fed an opportunity to begin reducing rates to a more neutral level, thereby supporting the economy. The rise in more favorable expectations began occurring around the time of the release of inflation figures for June, indicating that headline inflation is now down to 3%, and is expected to fall further in coming months. Core inflation has been stickier, but the lagging components of that index suggest downward momentum also.

Here is the way it is supposed to work. Inflation is the main problem, and it is too high because there is too much demand for goods and services relative to supply. To bring inflation back down to the 2% target, monetary policy has been tightened to reduce demand, and the expectation is that this will result in a rise in unemployment. When more people are out of work there is less demand in the economy. While this process is entirely logical, what is unknown is how high interest rates have to go and how long it will take for the higher rates to impact consumer and corporate behavior. Estimates are that this lag time can take as long as two years for the full effect of monetary policy to work its way through the economy.

In essence, the soft landing scenario rests on the assumption that the inflation rate can decline to a level at least near the 2% target while the unemployment rate remains near current levels. As noted above, once inflation is deemed to be under control, the Fed can assume supply and demand are back in balance and can begin reducing rates to a more neutral level, at which point a soft landing has been achieved.

What are the chances of this occurring? Based on historical experience, the odds are pretty low. It can happen, but it has not happened very often. And the main reason is that it is so difficult to determine at any time to what extent the policy moves have worked their way through the economy. That lag time we mentioned above is almost impossible to measure. You just have to wait to see the effect when it appears.

Think of employment as aggregate supply in the economy. It is not total supply, but it is a good measure. When demand increases so that it exceeds supply, as it did in response to the extensive Covid relief packages, inflation is created. As long as demand continues to exceed supply, inflationary pressures increase. But, when demand peaks there is a sweet spot that occurs when demand is falling but is not yet less than supply. In the sweet spot, inflation falls rapidly while the economy remains strong. Once falling demand becomes less than supply, overall spending is reduced, unemployment begins to rise, and a recession can occur.

Right now, we may be in that favorable period when demand is in retreat but is still greater than supply, and inflation is falling rapidly. The question is, will inflation fall far enough and fast enough before demand becomes definitively less than supply and recessionary pressures begin to build? The answer is that we do not know. The key will be when the Fed judges that demand is sufficiently lower than supply and begins to ease policy to avoid a recession. All of this involves a lot of fine tuning, and if they can pull it off it will probably require some measure of luck. We all understand the fickle nature of luck.

Our conclusion is that the recession scenario is still the most likely, but we sure do hope the soft landing actually happens. It will be better for the economy and it will be better for investors.