The State Space: March 2023:

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Welcome to our State Space series. Here you will find how we're thinking about the pathways and scenarios that could take us to critical economic states. We will never settle for "it's too unlikely." We try to reason backwards from the most important (tail-risk) scenarios, their most likely pathway to fruition, and the indicators that allow us to monitor the likelihood of each pathway. Today's post reflects a condensed version of what we hope to regularly lay out (at least once a month). Updates will share how these pathways are (or are not) playing out, and if new risk scenarios are potentially emerging.

The Baseline Scenario:

Growth is slowing but also stabilizing around a non-recessionary outcome *for now*. Inflation will take 12-18 months to firmly come back to pre-pandemic norm, due to an elongated lag in housing services inflation and still-unresolved goods production challenges that may only show more relief in the summer (e.g. autos).

- The US economy in Q4 was not as weak as it looked. Q1 will look stronger than the underlying trend.
- 2023 and 2024 should be years in which major inflationary impulses from the Russian invasion, a reopening economy, and the pandemic begin to dissipate, but that disinflationary road is likely to remain bumpy. Seasonal echoes and changing seasonal patterns are likely to drive ongoing data volatility.
- So long as growth looks resilient and inflation risks are elevated, the Fed is likely to keep hiking and pushing up its terminal rate projection. **The risks to the baseline emerge if 1) the Fed reaccelerates back to 50bp hikes and 2) if growth slows more noticeably in Q2 without at least proportional progress in inflation.**

The Pathway To Inflation Risk Scenarios:

Unresolved goods production challenges, exacerbated by global reopening. Contrary to popular consensus, goods and service inflation dynamics are not so easily separable, and actually exhibit strong correlation. Motor vehicle bottlenecks initially stoked goods inflation, but ultimately fed into changes in value-sensitive services, including rental, leasing, insurance, and repair. Food services are similarly sensitive to food prices. Airlines are sensitive both to jet fuel prices and global reopening dynamics. These goods production and pricing challenges could remain even if wage growth slows and the labor market cools. Latent risks stemming from global reopening and fragile Russian commodity supplies loom large here.

- **What to Monitor:** (1) Motor vehicle assemblies, (2) Goods-sector PPIs, (3) Consumer price trends for "food at home" (which are slowing but still running strong), and (4) the Fed's newly preferred "Core Services Ex Housing PCE" gauge.

The Pathway To Hawkish and Recessionary Scenarios:

Fed shifts into "hawkish panic" mode and stokes risk premiums in the process. The most likely pathway to more hawkish Fed policy and recessionary outcomes runs through the inflationary pathway. In that case, the Fed risks losing all remaining patience and panics in response. We already see signs that February, March, and possibly even April CPI could surprise above consensus. Used cars are flipping from deflation to inflation and residual seasonality issues are likely to remain through Q1. **Should the Fed shift back to 50bp hikes as a result**, and financial markets price in higher risk premiums in anticipation of recessionary outcomes, a self-fulfilling feedback loop can emerge.

- **What to Monitor:** (1) Near-term inflation data, (2) Near-term Fedspeak and hiking pace shifts (back to 50bps), and (3) Risk premiums (credit spreads).

The Pathway To Dovish Scenarios:

Slowing wage growth and job growth. If wage growth slows and job growth slows, the Fed may be willing to rethink some of their hawkish posturing, even if for sloppy analytical reasons (it's not really a great explanation for non-housing services PCE). There were more sustained signs of wage deceleration in 2022H2 than price deceleration. Wage growth is likely to slow further over the course of this calendar year as pandemic and reopening-driven turnover dissipates further, but the road is deceleration can still be filled with noise. Job growth is likely lifted in Q1 for residual seasonality challenges and will cool in Q2.

- **What to Monitor:** (1) Near-term inflation data, (2) Near-term Fedspeak shifts, and (3) Risk premiums (credit spreads).

The Upside Scenario:

Fiscal supports for labor market and fixed investment resilience. Much has been made of the growth- and inflation-related effects of consumer-oriented stimulus measures in 2020 and 2021, but less attention has been given to investment-oriented fiscal expansion over the past 18 months. Coupled with strong private sector balance sheets (as a result of prior consumer-oriented stimulus measures), these investment-oriented fiscal expansion measures have scope to stoke a stronger upswing in capital goods orders and production. The path to resilient growth and abating inflationary pressure is a real one but it will likely require patience through the next few months of still-volatile inflation releases. If key inflationary challenges resolve, we may still be left with a robust pace of economic growth.

- **What to Monitor:** (1) Employment growth in typically cyclical sectors (e.g. construction, manufacturing), (2) Hard data capital goods activity (orders, shipments, production, exports, imports).