Future Monetary Landscape Is Being Painted by Both Hard and Soft Data

Chartered Financial Analyst (CFA) Society Philadelphia's
80th Anniversary Celebration
Philadelphia, PA

October 19, 2023

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Good evening.

Thank you, Floyd, for that welcome and introduction, and my thanks to you and to Executive Director Pete Conners for putting together this evening's program.

I thank each of you as well for joining us this evening, given there is, shall we say, a competing event. I must note that this is the second time in as many weeks in which Major League Baseball did not first consult the Philadelphia Fed's event calendar when making the Phillies' playoff schedule. However, while I'm not particularly superstitious, when this happened last week, the Phillies won 10-2, so maybe there's something to this after all. But just in case, I'm wearing my Phillies tie.

I also congratulate you for the reason we're all here tonight — to celebrate the 80th anniversary of the CFA Society Philadelphia. Membership in an organization such as this isn't just a good thing to have for the networking opportunities or even for the chance to hear a Federal Reserve Bank president opine on monetary policy. It's also good for the industry and for your clients, as it puts confidence in your commitment to them and their financial futures and in the high standards of governance espoused by the CFA Society Philadelphia.

Now, speaking of monetary policy, I plan on sharing my overall thoughts and insights on the economic landscape before us — both nationally and in our region. Then, as Floyd said, we'll get this podium out of the way and get to having a conversation where we can drill down on specific issues. And believe me, as much as I may enjoy standing up here, I much more enjoy engaging in direct conversation.

But before we can get to any of this, there is one piece of business to which I must attend, and that is the usual Federal Reserve disclaimer: The views I express this evening are my own and do not necessarily reflect those of anyone else on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

I've recently boiled this down to the following: Anything I say tonight is a simple matter of "Pat said," *not* "The Fed said." So, let's use that.

As you can imagine, the thing I get asked about most — whether by the press, audiences such as yourselves, or even my friends — is interest rates.

So, let me begin by painting my picture of the economic landscape with the following broad brushstroke: Over the past several months, I have been clear in my view that, absent a stark turnabout in the data that I see and the on-the-ground testimonies of contacts that I hear, I believe that we are at the point where we can hold rates where they are. And so far, economic and financial conditions are evolving roughly as I expected, though I am keeping a close eye on the latest data, which have come in a tad stronger than my baseline forecast.

Let me roll back the clock a bit to 2022, when we started the pivot to a restrictive stance.

In a span of barely over a year, we not only did a lot, but we did it very fast. The policy rate went up by more than 5 percentage points, reaching its highest level in more than two decades. We also turned around our balance sheet policy, and we turned it around fast.

The speed in which we worked then is also part of my argument for holding steady now. The workings of the economy cannot be rushed, and we know there are lags, which mean that the full impacts of the higher rates may not yet be fully absorbed. I heard this very clearly from my discussions with contacts across the financial sector throughout the summer, as my viewpoint evolved to its current state.

Another part of my argument can be summarized this way: Doing nothing is doing something. And I think doing nothing at this moment equates to doing quite a lot. As long as policy rates remain restrictive, we will keep steadily pressing down on inflation and bringing markets into better balance.

And I further believe that a resolute, but patient, stance of monetary policy will allow us to achieve the *soft landing* that we all wish for our economy.

Look at the latest data on PCE inflation — it may have remained elevated in August at 3.5 percent year over year, but it is down 3 percentage points from this time last year. Even when the volatile aspects of energy and food costs are stripped away to give us the core measure of PCE inflation that economists believe is a better harbinger of trends, we also see clear signs of progress. In fact, the August monthly reading was its smallest month-over-month increase since 2020.

Now, that said, the available data for September have mostly come out stronger than I expected. The latest on retail sales confirms that households retained spending power and did not seem shy to use it over the summer. A resilient consumer is not a problem. Indeed, perhaps the key tenet of a soft landing is that households get to adjust their plan for when and how it best serves them — as opposed to the kind of drastic, unavoidable adjustments that come with, say, suddenly losing their job.

Truthfully, the momentum in consumer spending is a bit of a head-scratcher. Contacts talk of a more cautious, price-sensitive consumer. Major surveys also show a steady drop in consumer confidence since the summer. But there could have been some specific factors at play over the summer that we have yet to fully parse out, or we could be right on a turning point, or perhaps the fundamentals are even stronger for households.

We simply do not know. But we know that we do not know, and I believe that we should proceed accordingly: with caution and patience.

Let me be clear, though. Certainly, we are not going to tolerate a reacceleration in prices. I stand ready to revise my views and act accordingly if I see signs of reinflation. However, I am not going to overreact to normal month-to-month variability in the data.

And for all the fancy techniques, the best way to separate a signal from noise remains to average data over several months. Of course, to do so, you need several months of data to start with, which, in turn, demands that, yes, we remain data dependent but patient and cautious with the data.

And the data I do see, and all what I hear, point to a steady disinflation that is already under way and sustained, if slow. My projections have inflation dropping below 3 percent in 2024 and leveling out at our 2 percent target thereafter.

Of course, there's much more than just the policy rate at work here. There are numerous outside factors that are working in parallel with it to further push down on inflation.

For those in this room, I don't think I need to do much more than to point to the bond markets as a proof point. Certainly, the impacts of restrictive policy on bond prices across the yield curve are exerting their own pressures — and creating their own challenges along with it.

And, of course, there are also the tighter overall credit conditions that have existed since the collapses of Silicon Valley Bank, Signature Bank, and First Republic several months ago. In speaking with contacts over the summer, I heard that even while activity slowed, credit quality did not lag overall. Business lending continued for many, though it was reported to me that many borrowers were focusing more on financing for their "must haves," not their "like to haves."

There are other pressures that must be considered, too. The continued turmoil in the labor market is likely to similarly exert downward pressure on the economy — not just in the loss of overall economic activity but in the immediate impact on consumer spending as striking workers go without their usual wages.

There's also another elephant in this room, and that is the resumption of student loan payments. Again, we do not yet know the full scope this will have on consumer spending and savings, but we know that we do not know, so I am keeping a close eye on the matter.

And finally, we cannot forget that events around the world, and the uncertainty they bring, can have a real impact on our economy here at home. We are all watching, and in many cases praying about, the tragic situation in Israel and the Middle East, stemming from those recent terrorist attacks. And there is still Russia's ongoing war against Ukraine. Those are just two examples.

So, taking this all together, the picture painted is one that, I believe, shows that allowing the policy rate to remain steady is the prudent position.

"Well, Pat, that's all well and good, but when are rates going to come down," I hear you ask.

I wish I had an answer for you, but at this moment, I don't. My forecasts are based on what I know as of now. And as time goes by, as adjustments are completed, as new data emerge, and as we gain additional insight on the underlying trends, I may need to adjust my forecasts, and with them, my time frames. So, as inexact as the term "higher for longer" sounds and is, it's the best way I have to answer that question. Rates will need to stay high for a while.

It is not just the data that will signal to me when the time comes to adjust policy *either way*, but what I also hear from contacts and through outreach.

And I must note that while I really do not expect it, should inflation rebound, I would not hesitate to support further rate increases as our objective to return inflation to target is, simply, not negotiable.

Again, I say this with all the forecast data I have at this moment. And at this moment, I expect the economy's overall resilience to continue. Its underpinnings remain strong.

For starters, GDP growth has been outperforming estimates from earlier this year, and I do expect GDP gains to continue through the end of 2023, before pulling back slightly in 2024. But do not conflate a more moderate rate of GDP growth as a contraction. I do not anticipate a recession.

On the jobs front, I anticipate unemployment to end the year at about 4 percent — which is just slightly above where we are now — and to increase slowly over the next year to peak at around 4.5 percent, before heading back toward 4 percent in 2025.

This path would put the unemployment figure in line with the *natural rate of unemployment*, or that theoretical level where labor market conditions support stable 2 percent inflation.

Now, this does *not* mean that I expect mass layoffs. I do not.

First, we have seen months where the unemployment rate increased because more workers moved off the sidelines and back into the labor force. I expect us to continue to have such months. And second, I have to also balance the soft data I receive from my discussions with contacts — and many have related that, given how hard they've worked to find the workers they currently have, they are doing all they can to hold onto them.

The economic indicators tracked by the Philadelphia Fed also give me reason to feel positive about the path forward.

Among our most closely watched indicators are the manufacturing and nonmanufacturing business outlook surveys conducted with firms throughout the Third District. The latest *Manufacturing Business Outlook Survey* came out this morning. Now, while firms in both of the most recent surveys noted declines in month-over-month activity, the six-month outlooks reported in each remained optimistic overall.

In addition, we also publish a monthly summary metric of economic activity: the State Coincident Indexes. And in each state in our region — Delaware, New Jersey, and Pennsylvania — the overall long-range trend continues to be positive.

Such optimism is also borne out in some of the other hard data points we look at, including business formation. And here I would note, specifically, that the numbers of applications for high-propensity businesses — those expected to turn into firms with payroll — remain elevated across the board in the Third District when compared with prepandemic levels. And I also see the data showing that hotel occupancy rates, while not yet back to prepandemic levels, have continued to rebound.

I do take these as promising signs.

Of course, there are areas in which we have some concern. And specifically, I'll note the commercial real estate (CRE) sector. Office vacancy rates continue to be well above their prepandemic levels. Office space net absorption rates in the Philadelphia region continue to be negative. I do have some anxiety that last month's transition of the Wanamaker Building into receivership isn't going to be a one-off event.

And to be clear, to me, the issues surrounding CRE aren't just about the investments in the buildings themselves but also about the livelihoods of the businesses — especially the small businesses — which surround them and which are simply not getting anywhere near the foot traffic they did just a few years ago.

Now, I really want to step away from this podium and get to our conversation. But before we do, let me to pose the following question, which has nagged at me for months now as I've taken in data and formulated my position on the future direction of monetary policy: What in the economy has fundamentally changed from, say, 2018 or 2019?

In 2018, inflation averaged 2 percent almost to the decimal point and was actually below target in 2019. Unemployment averaged below 4 percent for both years and was as low as 3.5 percent, while policy rates peaked below 2.5 percent.

Now, I'm not saying that we're going to be able to exactly replicate prepandemic economic conditions. But the resilience of this economy is making me rethink some of the classic models.

And that's probably a good thing. After all, I'm not a classically trained economist — by education, I'm an engineer. And if you know anything about engineers, we're always willing to challenge previous assumptions and to look outside the box.

And if there's something else about engineers, we're also really good at judging the limits of a system, and I think I've just about hit my limit on my prepared remarks. I am eager to get to our conversation. So, Floyd, why don't we do away with this podium and get to it.

But one last thing: Go Phillies!