FOMC - December 2017

Unpacking the Fed's inflation conundrum

The next Fed chair will face the same challenge as Janet Yellen: muted inflation amid low unemployment

Drivers of low inflation

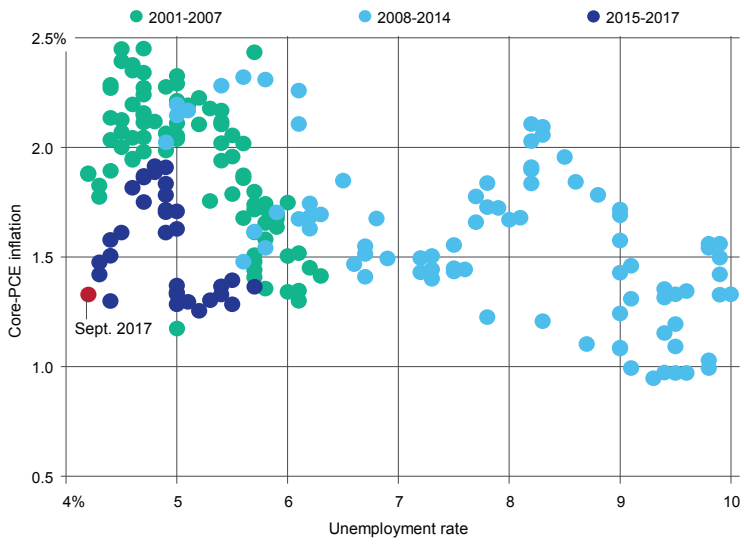
A tighter labor market should theoretically lead to higher wages and an increase in aggregate demand, which would push up prices. But both wage growth and the inflation rate have remained tame through the current expansion.

Several factors are contributing to subdued inflation…

- Cost-saving technological innovations
- Relatively subdued wage growth
- Weak global commodity price inflation
- Cheaper goods and services from China and other emerging markets

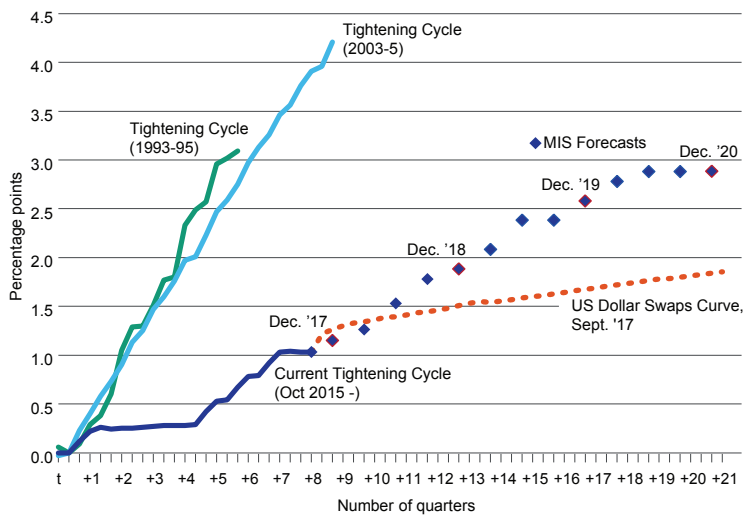
A flattening of the Phillips curve makes it more challenging to tighten monetary policy

US Phillips curve since 2001



Consequently, we expect the pace of tightening to remain more gradual than in prior cycles, consistent with lower potential growth and weaker inflationary pressures

Change in the policy interest rate from the beginning of the tightening cycle

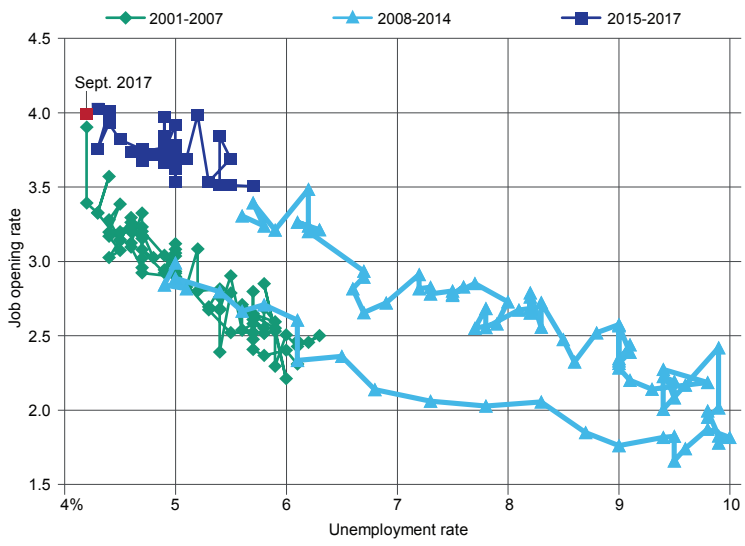


…and lower wages

- Demographic transition characterized by the exit of older, higher-paid workers from the labor pool
- Entry of the millennial generation at lower wages than the retiring baby boomers
- Increased automation and importance of the gig economy
- Weaker unions and workers' reduced bargaining power
- Slow labor productivity growth

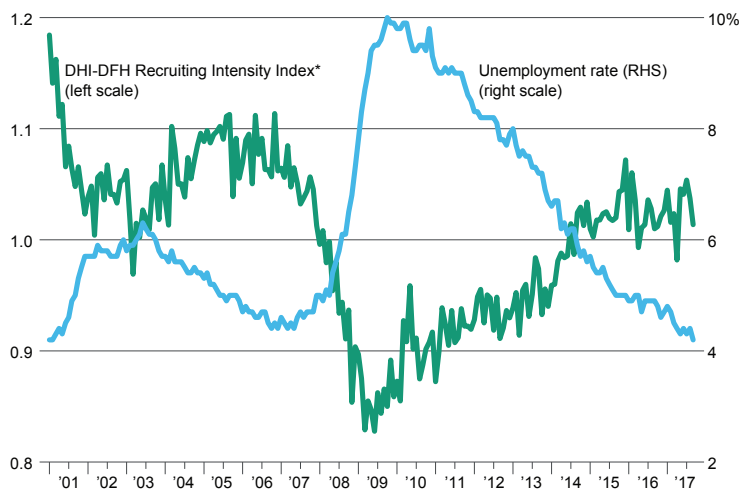
A greater mismatch between available jobs and the unemployed in terms of skills or location reflects 'hidden' slack in the labor market

US Beveridge Curve since 2001



As recruiting intensity continues to improve along with tightening labor markets, stronger wage pressures will likely materialize

Recruiting intensity per vacancy and unemployment rate, monthly



*Recruiting Intensity Index quantifies the effective intensity of recruiting efforts per vacancy by employers with vacant job positions

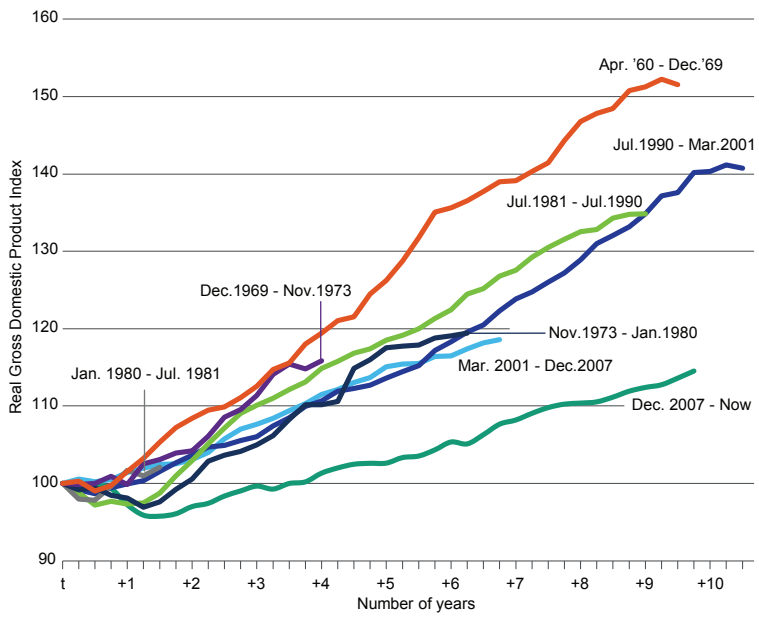
A business cycle like no other

Characteristics of current business cycle expansion

- Economic growth is slower than in previous seven expansions since 1960
- Inflation has been anchored at a relatively low level since the 1980s, while the economy approaches full employment nearly a decade after the last recession
- More recently, there are signs that inflation may have bottomed

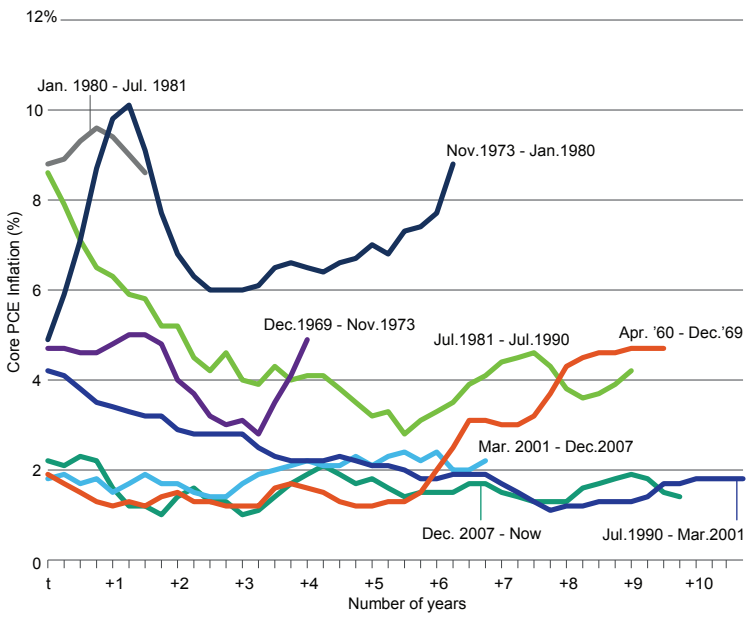
Economic growth much slower than in past cycles

GDP growth through US business cycle expansions (index)



Inflation through this cycle remains stubbornly low

Inflation through US business cycle expansions (%)



Credit implications

- Risk of a significant financial market disruption as the Federal Reserve continues to raise the policy rate and reduce the size of its balance sheet is mitigated by a transparent, well-communicated and gradual approach to monetary policy
- Relatively low nominal interest rates will continue to keep funding costs manageable
- Nevertheless, if inflation picked up faster than what is currently expected, it could trigger a sharp deterioration in financing conditions as financial markets adjust to the expectation of a steeper rise in interest rates
- Even in our baseline scenario, we expect pockets of rising credit risk as rising interest rates pressure highly leveraged issuers

Sources: Moody's Investors Service (Interest rate forecasts); FRED (Unemployment Rate, Core PCE Inflation, Effective Federal Funds Rate, Job Openings Rate, DHI-DFH Recruiting Intensity Index); Bloomberg (OIS); Haver Analytics (Real GDP Growth); National Bureau of Economic Research (Business Cycle Dates)