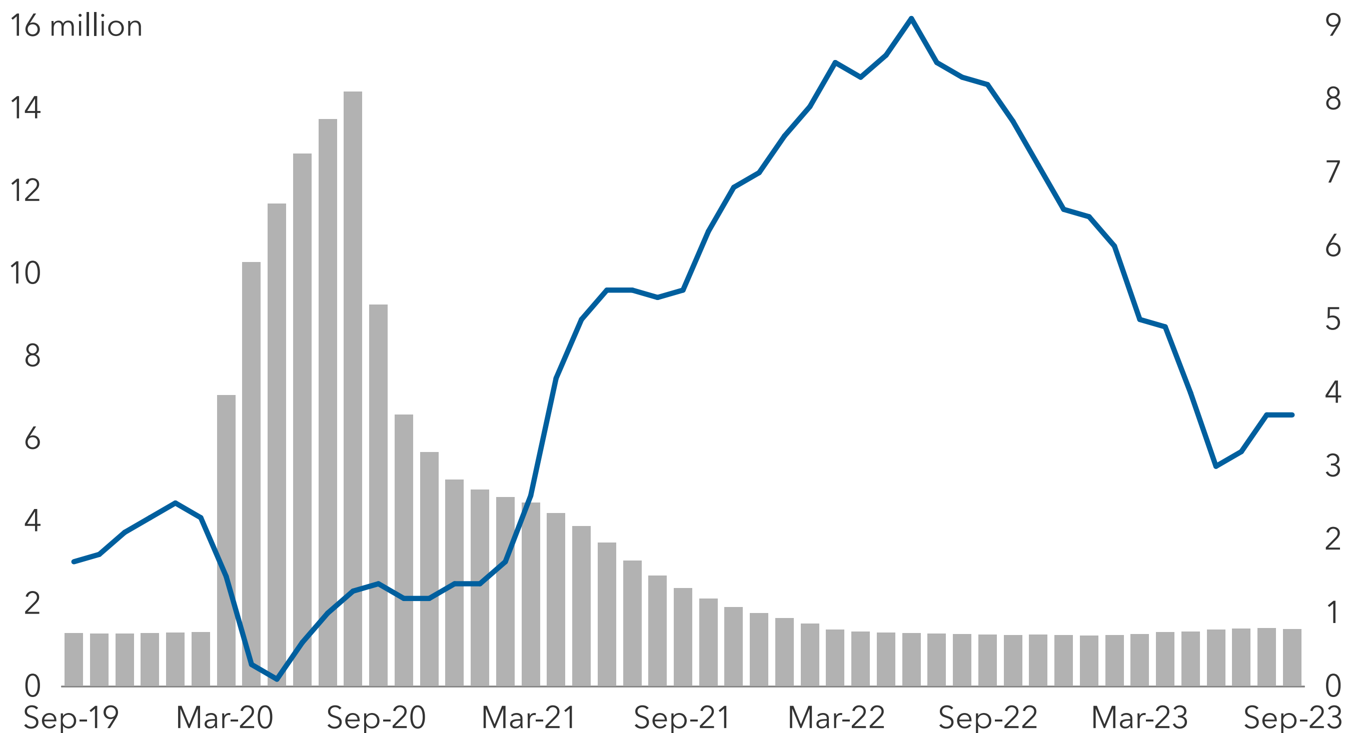
Fed’s 2% inflation target could be delivered early

Former Federal Reserve Chair Alan Greenspan said inflation is under control when consumers don’t have to think about it before making a purchase.

Twenty months into the current Fed’s rate-hiking cycle, people are still thinking about it. Prices remain uncomfortably high, with the Consumer Price Index (CPI) up 3.7% in September from a year ago.

Many investors are worried the final stretch to the Fed’s 2% inflation target will be challenging. However, there are signs that prices may ease substantially and, according to Capital Group economist Jared Franz, “the much anticipated 2% inflation baby could be delivered early.”

This comes as the U.S. economy and labor markets continue to hum, defying forecasts of a recession.



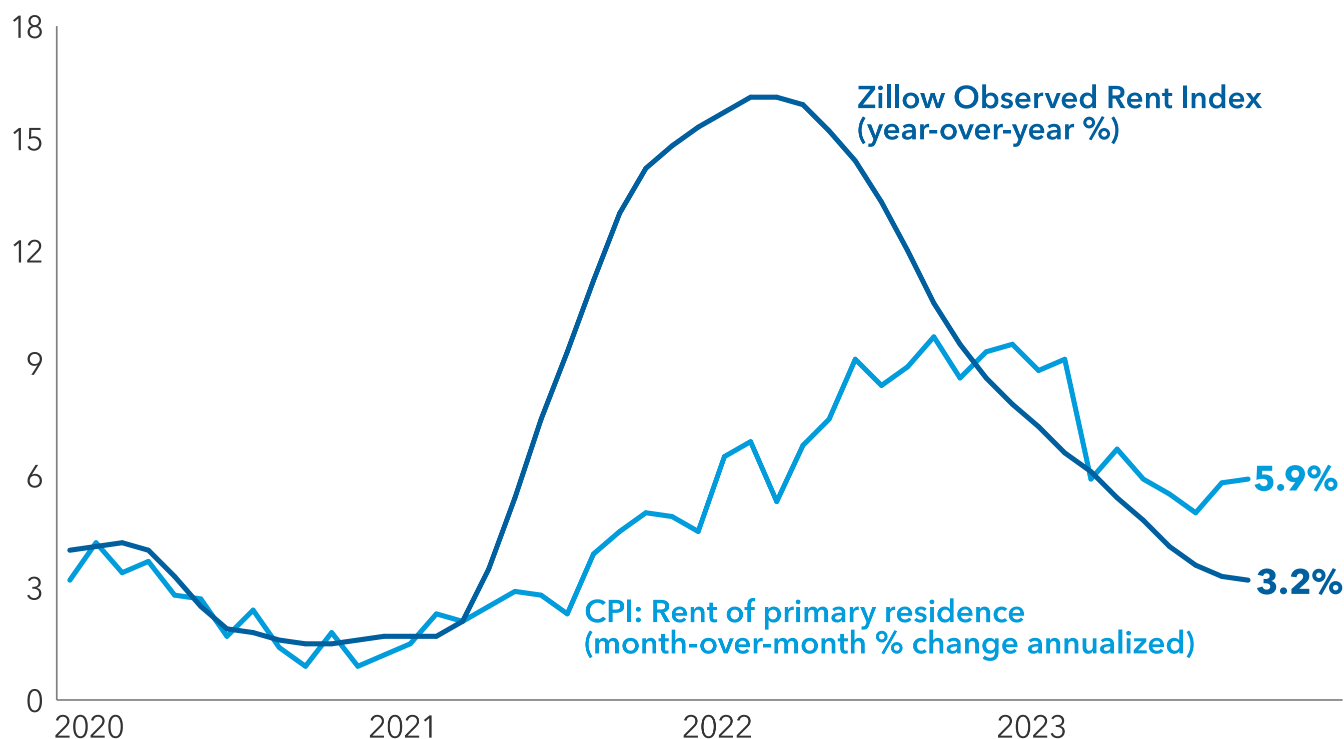
Sources: Capital Group, Bureau of Labor Statistics, U.S. Department of Labor. CPI is the year-over-year change in the Consumer Price Index for All Urban Consumers. Initial jobless claims represent new claimants for unemployment benefits. As of September 30, 2023.

Sky-high rent is falling

"The inflation story today is very different from 2022, and there is one big reason why: Rent has decelerated," says Franz. "Where rents go, inflation will eventually follow." So it makes sense that economists start with rent expectations to forecast CPI. Specifically, rent increases need to slow to 4% for the Fed to have any chance of achieving their target.

The post-pandemic surge in rent has fallen dramatically closer to that 4% figure. A look at the rent component of CPI shows that price increases slowed to about 5.9% in September from a peak of 9.1% in June 2022. Rent data from real estate company Zillow, which measures asking rent on new leases, has rent rising at an even slower pace of 3.2%.

It can take several months for lower rents – as tracked by Zillow and other sites – to flow to CPI. Nevertheless, as Franz puts it, "There may be some blips, but rent is speeding in the right direction."



Sources: Capital Group, U.S. Bureau of Labor Statistics, Zillow. The Zillow Observed Rent Index (ZORI) is a smoothed measure of the typical observed market rate rent across a given region (shown above for the entire U.S.) and is weighted to the rental housing stock to ensure representativeness across the entire market. The change in the ZORI is represented by the year-over-year percent change. CPI above refers to the Consumer Price Index for All Urban Consumers, and the line above represents the annualized monthly percent change in the Rent of Primary Residence component (average across all U.S. cities). As of September 30, 2023.

Meanwhile, productivity, which measures worker efficiency, has rebounded. Over the last four quarters, data from the U.S. Bureau of Labor and Statistics indicates that productivity has rebounded to 1.2%, while a related measure known as unit labor costs slowed to 2.5%. “These are patterns you see when economies start to heal,” Franz notes. Improved productivity and slowing unit labor costs place downward pressure on inflation.

Combined with stable commodity prices due to meager growth in China, Franz believes inflation could hit 2% by the end of 2024. That’s earlier than the Fed's median forecast of headline inflation at 2.5% and core inflation at 2.6%. The Fed’s preferred inflation measure is the core Personal Consumption Expenditures Index, which excludes food and gas, and generally tracks closely with core CPI.

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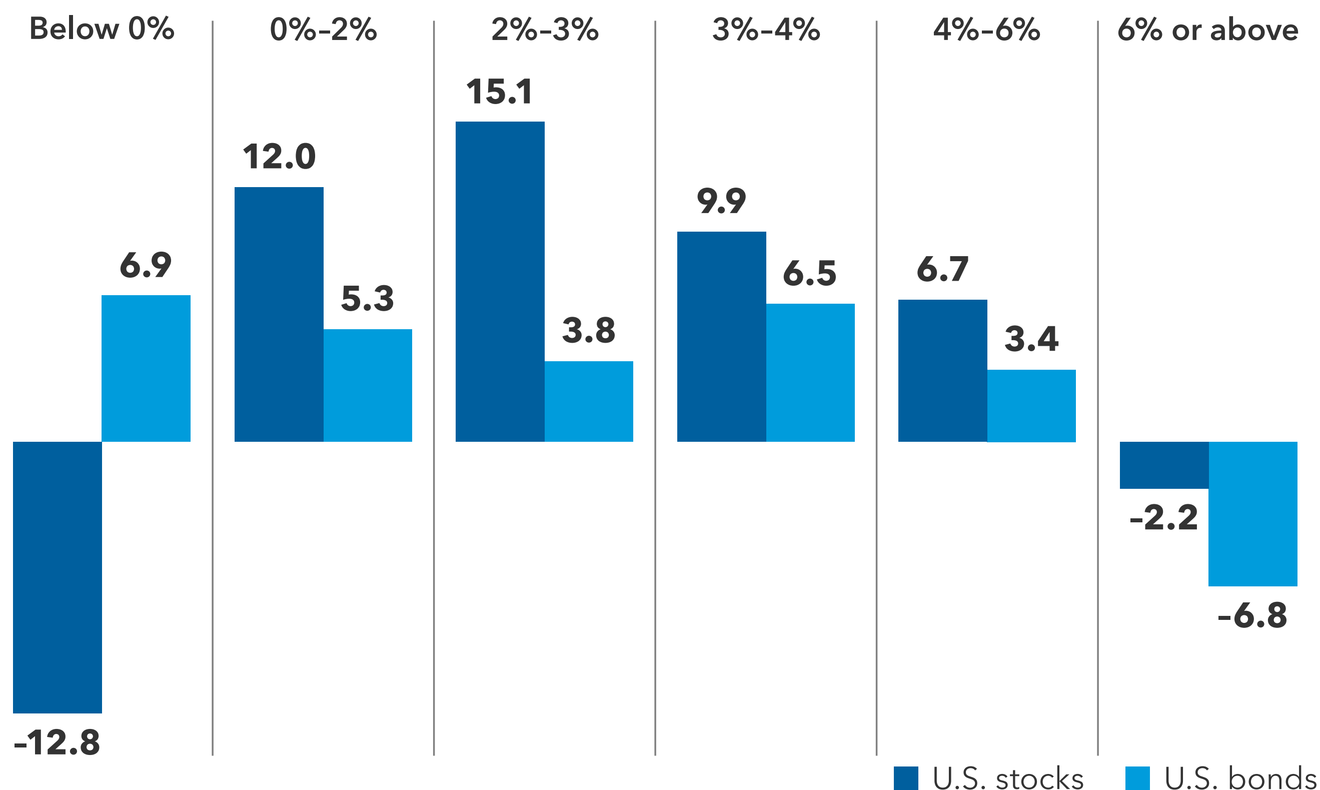
What if inflation gets stuck above 2%?

"If inflation was to hold steady at 3% it indicates to me that prices for an array of goods have resurged," Franz says. That scenario is less likely to happen.

One reason is because pandemic-era distortions such as the rapid growth in money supply, or M2, have reversed course. This broad measure of money in circulation has declined 3.7% from a peak of $21.7 trillion in July 2022 to $20.9 trillion in August 2023. M2 includes cash, coins, checking account deposits, savings accounts and money market funds. "There's a lot less money available to pay for goods and services, which just tells me that inflation will continue to fall," adds Franz.

Recall that the Fed's 2% goal is not a hard target and is instead an average over time, something officials announced without much fanfare in August 2020. Inflation nearing target could help propel U.S. stocks and bonds. Historically, the average annual returns for stocks and bonds were positive when inflation was in the range of 0% to 6%, with the best returns for stocks when inflation was between 2% to 3%. Past results, of course, do not predict future returns.



Sources: Capital Group, Bloomberg Index Services Ltd., Bureau of Labor Statistics – U.S. Department of Labor, Standard & Poor's. All returns are inflation-adjusted total real returns. U.S. stock returns are represented by the S&P 500 Index. U.S. bond returns are represented by the Bloomberg U.S. Aggregate Bond Index. Inflation is represented by the year-over-year change in the U.S. Consumer Price Index (CPI) for all urban consumers. Data is monthly from December 31, 1976 – September 30, 2023. Past results are not predictive of results in future periods.

The Israel-Hamas conflict bares monitoring as a sustained increase in energy prices may result in an upside risk to the inflation outlook. Franz believes a reacceleration of inflation could pressure the Fed to keep rates high for an extended time frame.

The Fed has worked hard to gain credibility, so it is unlikely to change the inflation target as it continues its efforts to promote financial stability.

Can we reach 2% inflation without a hard landing?

Blame it on the U.S. consumer. With unemployment near a 50-year low at 3.8%, the recession that’s just around the corner remains elusive as consumers continue to outrun gloomy growth expectations. High rates have chilled some parts of the economy, but that

process has so far happened at separate times in varying industries. To be sure, the recent rise in long-term interest rates has raised hard questions about the government's total debt burden and just how much longer consumers can keep the economy going.

Massive pandemic-era stimulus provided temporary relief for many households and directed new federal spending toward clean energy via a mix of tax incentives, grants and loan guarantees. But with student loan payments resuming in October after a yearslong pause, will consumer spending flatline?

Consumers have largely exhausted excess savings from the COVID-19 years, but the recent increases in wage growth are expected to go directly into spending. The impact from the resumption of student loan payments will likely be minimal, with borrowers expected to cut their spending by about $56 on average per month, according to the Federal Reserve Bank of New York.

Meanwhile "government spending for certain industries such as industrials will continue to bleed into the recovery over the next five years," Franz notes. Some aspects of pandemic-era stimulus may last well beyond that window.

In short, the U.S. government will likely continue to support the economy by creating demand for goods and services. That could help keep labor markets in check and a recession at bay. Job growth has been robust, with 336,000 jobs added in September.

"As long as we're pumping out monthly jobs growth above 120,000, the economy will continue to tread water," concludes Franz. "I haven't been as bearish about the economy because labor markets have been so good, and I think the U.S. can print 2% GDP growth over the next year."

__Jared Franz__ is an economist with 17 years of industry experience (as of 12/31/2022). He holds a PhD in economics from the University of Illinois at Chicago and a bachelor's degree in mathematics from Northwestern University.

The market indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

Bloomberg U.S. Aggregate Index represents the U.S. investment-grade fixed-rate bond market.

The **Consumer Price Index (CPI)** is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The **S&P 500 Index** is a market capitalization-weighted index based on the results of approximately 500 widely held common stocks.

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