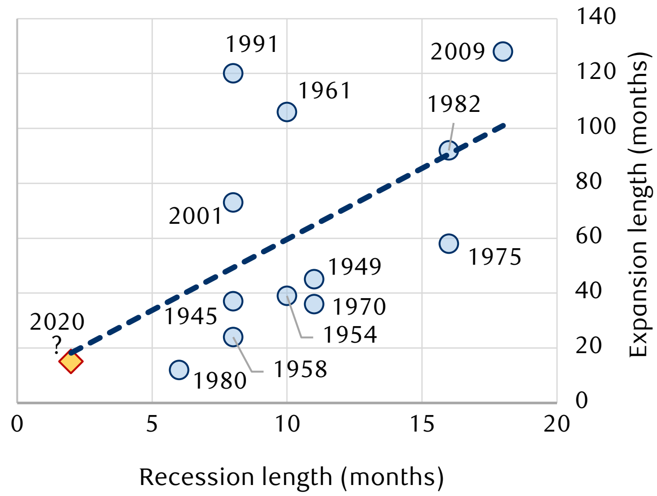
Inflation fears subside as inflation ramps up

Of course, inflation once again featured heavily during Powell's press conference, but the narrative was largely the same: near-term pressures have been driven by specific sectors of the economy, and are expected to fade. The Fed is still focused on longer-term inflation expectations, and the fear that they could become unhinged from the policy goal of price stability. But as highlighted once again, "Indicators of longer-term inflation expectations appear broadly consistent with our longer-run inflation goal of two percent."

And that dynamic can be seen in the chart on the previous page, as the July University of Michigan Surveys of Consumers reveal that consumers still see inflation as only being temporary, whereas long-term inflation expectations remain essentially in line with historically average levels. The same dynamic persists in market-based pricing of the inflation outlook as well, which has actually declined in recent weeks.

Does a short recession mean a shorter expansion?

Postwar business cycles



Source - RBC Wealth Management, Bloomberg, National Bureau of Economic Research; shows business cycles since 1945

Two distinct timelines

Also notable from this meeting was Powell's attempt to decouple the Fed's tapering plans from the future rate hike process. While current economic conditions may in fact warrant a reduction in bond purchases, it does not necessarily mean that they too will warrant rate hikes when that time comes.

The market has traded with some trepidation because of the idea that tapering asset purchases comes first, followed then by rate hikes. In our view, the Fed will likely hit the reset button if and when the tapering process is completed, potentially in late 2022, and will then take a fresh look at the inflationary and labor market environments. Put another way, starting the clock on tapering in no way starts the clock ticking on the next rate hike cycle.

If you can't build it, they won't come

Next up was the first look at Q2 GDP, which significantly missed consensus forecasts, printing at just 6.4 percent on an annualized basis against expectations of 8.4 percent. However, the details of the report were perhaps more encouraging than the headline shortfall would suggest for a number of reasons.

What's interesting is what contributed to growth, and what did not. Consumption data on goods and services was well ahead of expectations, a sign that demand remains robust as the economy continues to reopen, particularly for services as demand shifts away from pandemic-driven goods spending. But the drag on growth came from negative readings on residential investment (on a lack of housing supply, a decline in inventories), yet another sign of supply chain constraints, and from a pullback in federal government spending compared to past quarters—which could reverse with an infrastructure bill.

That's where the bright side comes in. Those kinds of factors typically mean that spending and growth have simply been delayed to future quarters, which could be key as investors increasingly ponder what this business cycle—and its durability—is going to look like. There have been some fears that a too-rapid recovery might actually risk shortening this expansion after a short recession, which the National Bureau of Economic Research recently dated at just two months long in 2020.

As the chart above shows, there is at least some correlation between the length of recessions, and the length of the subsequent economic expansion. Where demand remains robust, perhaps the supply-side constraints will act as a natural speed limiter, adding longevity to this expansion which has already entered its 15th month.

Rolling with it

As we have so often said over the past year, just as the pandemic was unprecedented for the global economy, so too will be the recovery. The recent volatility in certain economic data has only confirmed that, while the Fed has worked to finesse its near-term messaging in an environment of persistent and heightened uncertainty. Markets largely took these events in stride this week, with Treasury yields holding steady and U.S. stocks setting fresh record highs, perhaps taking the long view: the Fed will likely remain accommodative for years to come, and even amid fits and starts, the economy remains on the right trajectory.