Daiwa Capital Markets

U.S. Data Review

- Powell at Jackson Hole: the Philips curve has died, or is at least in a coma
- Q2 GDP: inconsequential upward revision

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The Fed's Strategic Framework

Fed Chair Jerome Powell used his Jackson Hole speech to introduce the revisions to the Federal Reserve's policy framework, which has been under review since early last year. As widely expected, the Fed altered its inflation-targeting regime. The Fed retained an inflation target of 2.0 percent for the personal consumption expenditures price index, but Chair Powell noted that the target applies to the average inflation rate over some unspecified period of time. The shift is significant in that it signals that the Fed will tolerate inflation above target for a time if inflation has been below target. As shown in the chart, inflation has indeed been below target most of the time in the past several years, and thus officials will not be alarmed or quick to tighten policy if inflation breaches 2.0 percent.

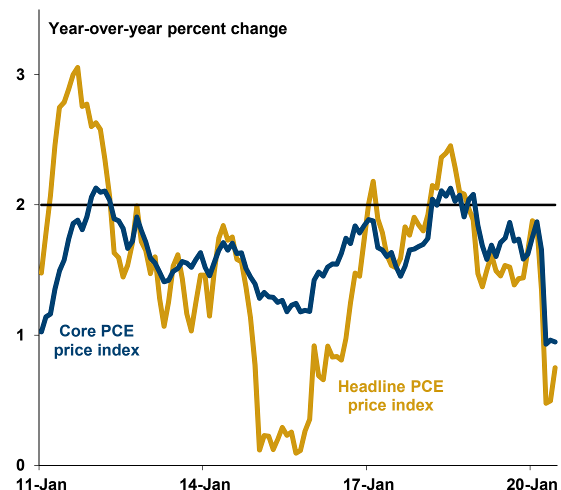
While the Fed is now more flexible in pursuing its inflation goal, it is not likely to allow pronounced movement above 2.0 percent for an extended period. The new statement on goals and strategy released by the Fed noted that officials will tolerate inflation moving ***moderately*** above 2.0% ***for some time***. The inclusion of these modifiers suggests that the Fed does not intend to let inflation get out of hand.

Most observers are likely to view the new targeting framework as vague. What, exactly, does "moderately" and "for some time" mean? The framework is indeed vague, and this is by design. Chair Powell emphasized in his speech that policy changes will not be dictated by a particular definition of average or some mathematical formula. Policy changes will be driven by "a broad array of considerations".

The shift in inflation strategy was notable, but we were more struck by changes related to the Fed's goals for maximum employment. As was the case previously, the Fed did not establish a numerical goal for employment or unemployment because conditions that satisfy maximum employment are difficult to define and will change over time. However, the Fed altered the statement on employment goals by noting that the Fed would resist "shortfalls" of employment from what might be perceived as its maximum level. The previous statement referred to "deviations" of employment from its maximum.

As Chair Powell noted in his speech, the shift in the statement is significant because it signals that Fed officials do not view tight labor markets as having inflation consequences. The relationship between unemployment and wage growth or inflation had been weakening for some time, and the experience in the latest expansion showed no meaningful response of inflation to decades-low unemployment. Thus, Fed officials have effectively concluded that the Philips curve (the relationship between labor market conditions and inflation) is no longer relevant. Perhaps it is too strong to say that the Fed has declared the Phillips curve to be dead, as the Fed plans to review its strategy every five years, and the situation could be different down the road. However, if the Philips curve is not dead, Fed officials view it as in a coma.

PCE Price Indexes*



PCE = personal consumption expenditures

** The horizontal line at two percent is the inflation target of the Federal Reserve.*

Source: Bureau of Economic Analysis via Haver Analytics; Federal Open Market Committee

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Revised Q2 GDP

The U.S. economy in the second quarter was not as soft as previously believed, but the upward adjustment was minuscule relative to the magnitude of the contraction. The new estimate shows a drop of 31.7 percent, 1.2 percentage points better (i.e. less negative) than the initial estimate of -32.9 percent. The consensus estimate called for an upward revision of 0.4 percentage point to -32.5 percent). The revision was broadly based, as all major components showed slightly better results.

Today's report included the first estimate of aggregate corporate profits, and the results matched the weak tone of the overall economy. After tax profits fell 11.8 percent (not annualized), a figure that translates to a compound annual decline of 39.5 percent. The loss was concentrated in the nonfinancial sector; profits of financial corporations rose moderately.

GDP and Related Items*

		20-Q1	20-Q2(a)	20-Q2(p)
1.	**Gross Domestic Product**	-5.0	-32.9	-31.7
2.	**Personal Consumption Expenditures**	-6.9	-34.6	-34.1
3.	**Nonresidential Fixed Investment**	-6.7	-27.0	-26.0
3a.	**Nonresidential Structures**	-3.7	-34.9	-33.4
3b.	**Nonresidential Equipment**	-15.2	-37.7	-35.9
3c.	**Intellectual Property Products**	2.4	-7.2	-7.7
4.	**Change in Business Inventories (Contribution to GDP Growth)**	-1.3	-4.0	-3.5
5.	**Residential Construction**	19.0	-38.7	-37.9
6.	**Total Government Purchases**	1.3	2.7	2.8
6a.	**Federal Government Purchases**	1.6	17.4	17.6
6b.	**State and Local Govt. Purchases**	1.1	-5.6	-5.5
7.	**Net Exports (Contribution to GDP Growth)**	1.1	0.7	0.9
7a.	**Exports**	-9.5	-64.1	-63.2
7b.	**Imports**	-15.0	-53.4	-54.0
	Additional Items			
8.	**Final Sales**	-3.6	-29.3	-28.5
9.	**Final Sales to Domestic Purchasers**	-4.6	-28.2	-27.6
10.	**Gross Domestic Income**	-2.5	--	-33.1
11.	**Average of GDP & GDI**	-3.7	--	-32.4
12.	**GDP Chained Price Index**	1.4	-1.8	-2.0
13.	**Core PCE Price Index**	1.6	-1.1	-1.0
14.	**After-tax Corp. Profits (not annualized)**	-11.0	--	-11.8

** Percent change SAAR, except as noted*

(a) = advance (1st estimate of GDP); (p) = preliminary (2nd estimate of GDP)

Source: Bureau of Economic Analysis via Haver Analytics