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FED SHADOW

FOMC Preview: Yes, There Was Some Good News in Friday's CPI

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Donald Luskin

…and Powell's post-confirmation confirmation bias will make him recognize it.

With the FOMC on-deck for Wednesday, *markets are in full-on tantrum mode*, with last Friday's worse-than-consensus May CPI data (see "Data Insights: CPI/PPI" June 10, 2022) raising *policy expectations to levels associated not with normalization, but a deliberate attempt to slow the economy*. Just before the May FOMC, markets expected the funds rate to be 3.13% by next February, with a 36% chance of a 75 bp hike this week. When that meeting proved to be surprisingly dovish (see "On the May FOMC" May 4, 2022), markets lowered those expectations to 2.95% and zero, respectively. *But now Fed-fear is back with a vengeance. Markets expect a 3.67% funds rate in February, two hikes more than expected at the May FOMC. The chance of a 75 bp hike this week is now 40%*.

This is especially unfortunate because in one important sense the May CPI data was quite encouraging (please see the chart below).

Update to strategic view

FEDERAL RESERVE: Markets are throwing a tantrum ahead of Wednesday's FOMC. Based on last Friday's worse-than-expected May CPI report, expectations have built in another two rate hikes and some probability of a 75 bp hike on Friday, implying a …

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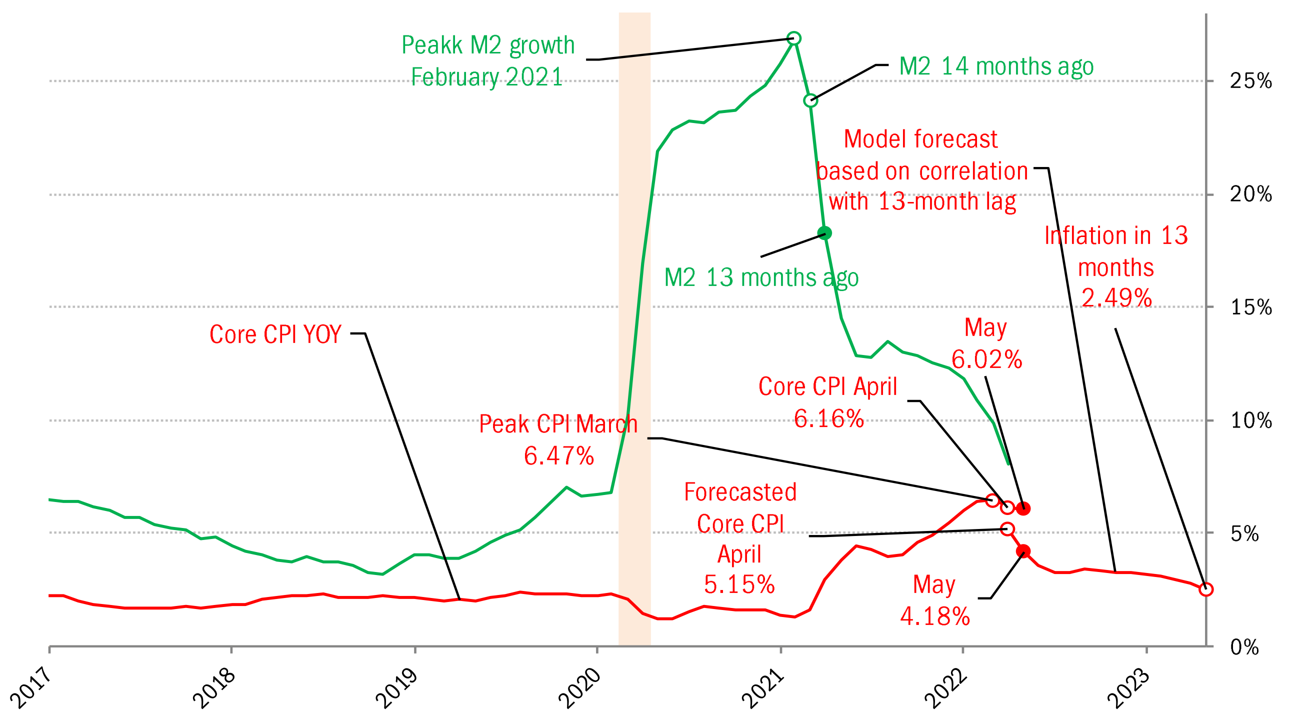
Core CPI model based on YOY growth in M2 money supply



Source: US Treasury, BLS, TrendMacro calculations

- We have demonstrated the Core CPI year-over-year is extremely highly correlated with year-over-year changes in the M2 money supply, with a 13-month lag (from 2017 to present, the regression equation has an R-squared of about 90; see "Video: What you're not hearing about what caused today's inflation, and where it's going" June 9, 2022).
- With the cessation of major pandemic relief spending, M2 has been decelerating sharply since its peak in February 2021, corresponding perfectly – with a 13-month lag – with the peak in Core CPI in March. M2 growth fell in March 2021, and April Core CPI fell also, as predicted. *The good news in May's otherwise awful CPI data is that with M2 having decelerated further in April 2021, May Core CPI decelerated too, now for the second month in a row, with the usual 13-month lag* (again, please see the chart on the previous page).
- To be sure, the regression equation forecasted that Core CPI would fall more than it actually did – but it fell. *The fact remains that as M2 growth decelerates, that is indeed passing through with a lag into lower rates of core inflation.*
- *In other words, the policy changes required to bring inflation rates lower were already set in motion early last year and are beginning to have their expected effects. Now as M2 growth approaches the normal historical range, we can expect inflation to do so as well with at 13-month lag. The regression equation predicts that Core CPI will be 2.49% in 13 months.*
- *No policy change from the Fed is required – only patience.* The path of core inflation, at least for the next 13 months, is already pre-determined by past M2 growth. We believe the Fed should normalize policy rates in order to keep inflation at target beyond that horizon, but that's a second-order consideration.
- By the way, the Fed's preferred measure of core inflation – Personal Consumption Expenditures, rather than the Consumer Price Index – also decelerated in March and April. We – and the Fed – won't know about May until it is reported by the Bureau of Economic Analysis on June 30.
- Is three months of sequential deceleration in Core CPI the "clear and convincing evidence" of decelerating inflation that Fed Chair Jerome Powell says he's looking for (see "Video: What you're not hearing about when inflation is finally going to be transitory" May 24, 2022)?
- To be sure, it could be a lot clearer and a lot *more* convincing. But Powell is finally ensconced after an agonizing wait to be confirmed as Chair for a politics-proof four-year term. We think his post-confirmation confirmation bias is such that he'll want to find the good news among the bad news in last Friday's report – especially with markets practically begging him to remember he wields The Fed Put. Besides, who wants to cause a recession if you don't have to?
- We'll find out on Wednesday afternoon. *But it should be… at least it should be enough to prevent a 75 bp hike and inspire some hints from the Chair that we can at least "wait and see."*
- *Markets will likely be quite relieved.*

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…policy path more aggressive than mere normalization. But Core CPI on a year-on-year basis decelerated for the second month in a row, perfectly corresponding to the similar deceleration in M2 growth after its peak in February 2021 (the two are highly correlated with a 13-month lag). As the further already-accomplished deceleration of M2 growth feeds into inflation with a 13-month lag, Core CPI will continue to decelerate. All the Fed has to do is wait, because the cessation early last year of massive pandemic spending programs is already a sufficient policy response to lower inflation. Based on the regression equation linking M2 and inflation, Core CPI will be 2.49% year-over-year in May 2023. Following his long-delayed confirmation for a second term, Powell will likely want to look for this good news among the bad news in Friday's report, all the more so with markets begging him to remember he wields The Fed Put. We do not expect a 75 bp hike on Wednesday, and we look for surprisingly comforting words from Powell. Markets will be relieved.

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Bottom line

Markets are throwing a tantrum ahead of Wednesday's FOMC. Based on last Friday's worse-than-expected May CPI report, expectations have built in another two rate hikes and some probability of a 75 bp hike on Friday, implying a policy path more aggressive than mere normalization. But Core CPI on a year-on-year basis decelerated for the third month in a row, perfectly corresponding to the similar deceleration in M2 growth after its peak in February 2021 (the two are highly correlated with a 13-month lag). As the further already-accomplished deceleration of M2 growth feeds into inflation with a 13-month lag, Core CPI will continue to decelerate. All the Fed has to do is wait, because the cessation early last year of massive pandemic spending programs is already a sufficient policy response to lower inflation. Based on the regression equation linking M2 and inflation, Core CPI will be 2.49% year-over-year in May 2023. Following his long-delayed confirmation for a second term, Powell will likely want to look for this good news among the bad news in Friday's report, all the more so with markets begging him to remember he wields The Fed Put. We do not expect a 75 bp hike on Wedneday, and we look for surprisingly comforting words from Powell. Markets will be relieved.

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