Trend Macro™

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TRENDMACRO LIVE!

On the June FOMC

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A panic based on a fallacy based on misinterpretation of data. At least it's over.

With all due respect to those who feel differently, we think the Fed has made a stupid mistake in an atmosphere of baseless panic, treating a single CPI report – which was, in fact, optimistic about progress on inflation – as grounds for emergency action.

On a day when the European Central Bank convened an emergency meeting at which it decided to restart a dormant asset purchase program – to deal with tightening global financial conditions driving potential systemic risks from rising euro area sovereign yields – our central bank has decided to make financial conditions even tighter.

We've been too optimistic about Powell since his reconfirmation (see "Video: What you're not hearing about when inflation is finally going to be transitory" May 24, 2022). The best we can say about today's FOMC is that it's over. Market expectations were approximately ratified. *The one upside surprise is that Powell said in the post-meeting press conference*

Update to strategic view

FEDERAL RESERVE, US MACRO: A 75 bp hike, and a sharp move up in the "dot plots" raising the terminal funds rate in this cycle close to 4%. Market expectations were shaped to expect this on Monday, so no negative surprise. A positive surprise is that Powell said that another 75 bp move was unlikely. The Fed has panicked, based on a fallacious…

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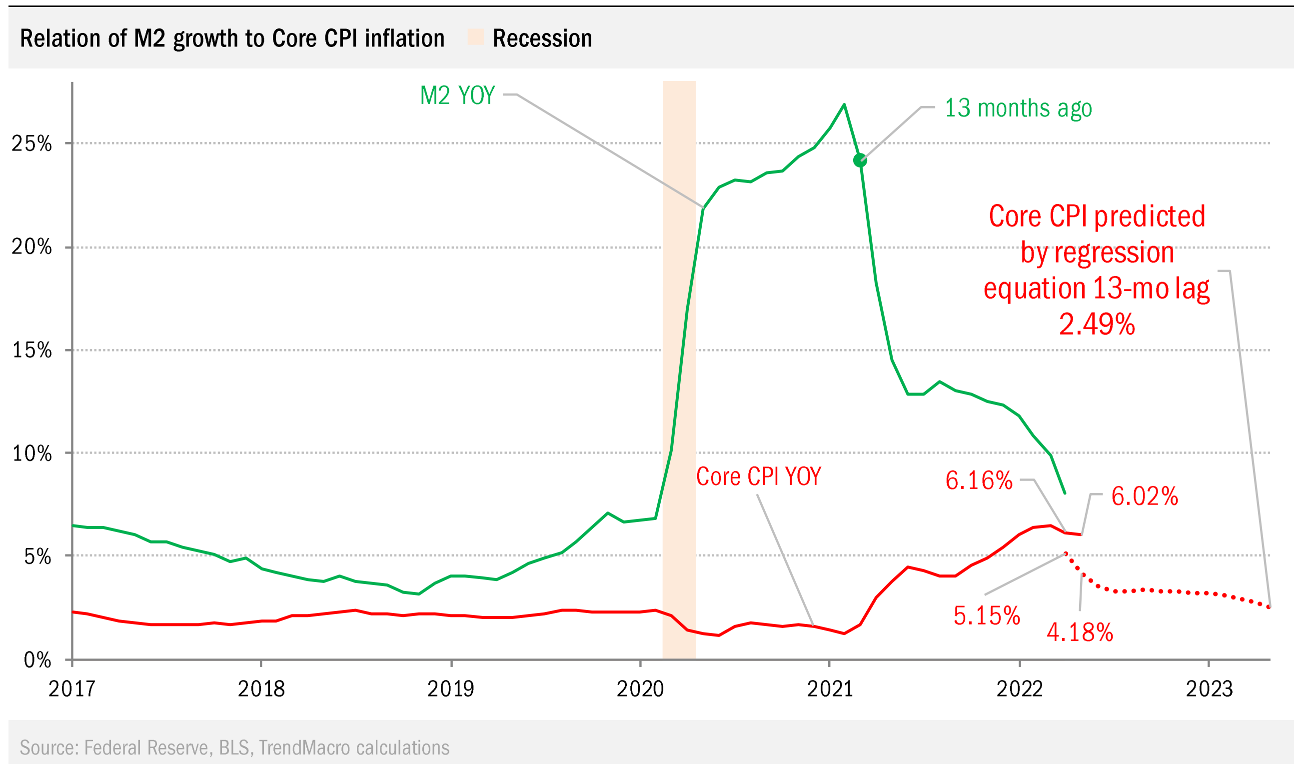
Relation of M2 growth to Core CPI inflation



Source: Federal Reserve, BLS, TrendMacro calculations

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that today's will likely be the last 75 bp hike. There were no substantive changes in [the text of today's June FOMC statement].

We'll get into more details in a moment, but we want to start with some relevant conceptual background.

- *The panic appears to be grounded in what we consider to be a fallacy about what inflation is and what it takes to deal with it.*
- The empirically demonstrable reality is that inflation is a dynamic economic wave-front that moves through the economy, with a lag, in the wake of large increases in the money supply (see "Video: What you're not hearing about what caused today's inflation, and where it's going" June 9, 2022).
- As Milton Freidman put it in 1970, "Inflation is always and everywhere a monetary phenomenon." Its particular points of impact are determined by real-economy factors such as today's supply-chain disruptions. But without excess growth in money, those factors could not lead to inflation, only to economic contraction.
- Today's inflation is very closely following, with a 13-month lag, the large increase in M2 that was entirely driven by a sequence of large Covid income-support programs. Those programs have ceased, and M2 growth is returning to normal. No more stimulus plans are likely. Core CPI peaked two months ago, 13 months after the peak in M2 growth. It has lessened sequentially each month since then (please see the chart on the first page).
- *Like a wave in the ocean, inflation dissipates when the energy that set it in motion is no longer being applied*.
- But it seems the mere fact that headline CPI is 4 bp higher than it was when the FOMC last met in May is, for the Fed, sufficient proof of an alternate theory of inflation, which we hold to be an utter fallacy.
- *Rather than seeing inflation as a dynamic wave, the fallacy holds that inflation is a static object which, once it has come into existence for whatever reason, persists until something is done by the Fed to expel it*. It is as though an ocean wave, once generated, never dissipates unless some counterforce is applied to it. *This is to see inflation as a perpetual motion machine, which is fallacious from first principles*.
- *The fallacy includes the notion that the only counterforce that can expel the inflation object is for the Fed to raise the funds rate above the inflation rate.* We are amazed to hear this said so often as though it were an axiom. At best it's a normative theory, and that theory is based on a single historical episode – the tightening cycle in the early 1980s implemented by then-Chair Paul Volcker (see "On Inflation, If You Don't Study History…" June 13, 2022).

Even if you subscribe to the fallacy, don't make matters worse by misinterpreting data that is actually saying no panic is necessary.

- *Today's 75 bp rate hike is being made on the basis of a single*

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…understanding of inflation inflamed by an erroneous understanding of Friday's CPI data. A correct reading shows inflation already moderating over the last three months, in line with the year-ago cessation of pandemic spending programs and the corresponding moderation of M2 money growth. Powell was clear that coming inflation reports will determine the policy path. Today's new funds rate is not itself restrictive. The improving inflation data we confidently expect will keep the future path of policy from being crushingly restrictive.

[Strategy Dashboard home]

Consumer Price Index report released just four days ago which, on the one hand, disappointed the Wall Street consensus with a headline inflation rate of 8.58% (8.3% had been expected) but, on the other hand, was only 4 bp higher than it had been the last time the FOMC met, *with Core CPI at 6.02%, 45 bp lower than at the prior meeting and the second sequential drop in a row* (see "An Open Letter to Jerome Powell" June 14, 2022).

- Indeed, favorable developments were already visible in the data even at the time of the May FOMC. In that meeting's minutes, "A number of participants observed that recent monthly data might suggest that overall price pressures may no longer be worsening" (see "Data Insights: FOMC Minutes" May 25, 2022).
- To be fair, we could justify the panic on the grounds that something *isn't* happening. Internals aside, *headline inflation isn't better than it was at the May FOMC, and so a case could be made that we lack what Fed Chair Jerome Powell has called "…clear and convincing evidence that inflation pressures are abating and inflation is coming down."* Therefore, as he said, "*if we don't see that, then we'll have to consider moving more aggressively*." [emphasis added]
- That's certainly the view markets took the moment the report was released Friday morning, and by Monday, it seemed that Powell was ratifying it. The *Wall Street Journal's* ace Fed-watcher Nick Timiraos reported that the FOMC was "likely… to consider surprising markets" with a 75 bp hike. Merely "likely." Only "to consider." But that's enough, isn't it. And no source cited, but Timiraos is known as the reporter Powell calls when he wants to leak something during the pre-FOMC quiet period.
- *So today's 75 bp hike wasn't exactly a surprise*. It was fully built into expectations implied in the futures market by end-of-day Monday (the market-implied probability was almost zero last Thursday, and only 40% on Friday even after the CPI report came out). As Timiraos puts it, "Powell has avoided surprising markets on the day of policy meetings." Well, apparently he doesn't mind surprising them two days before.

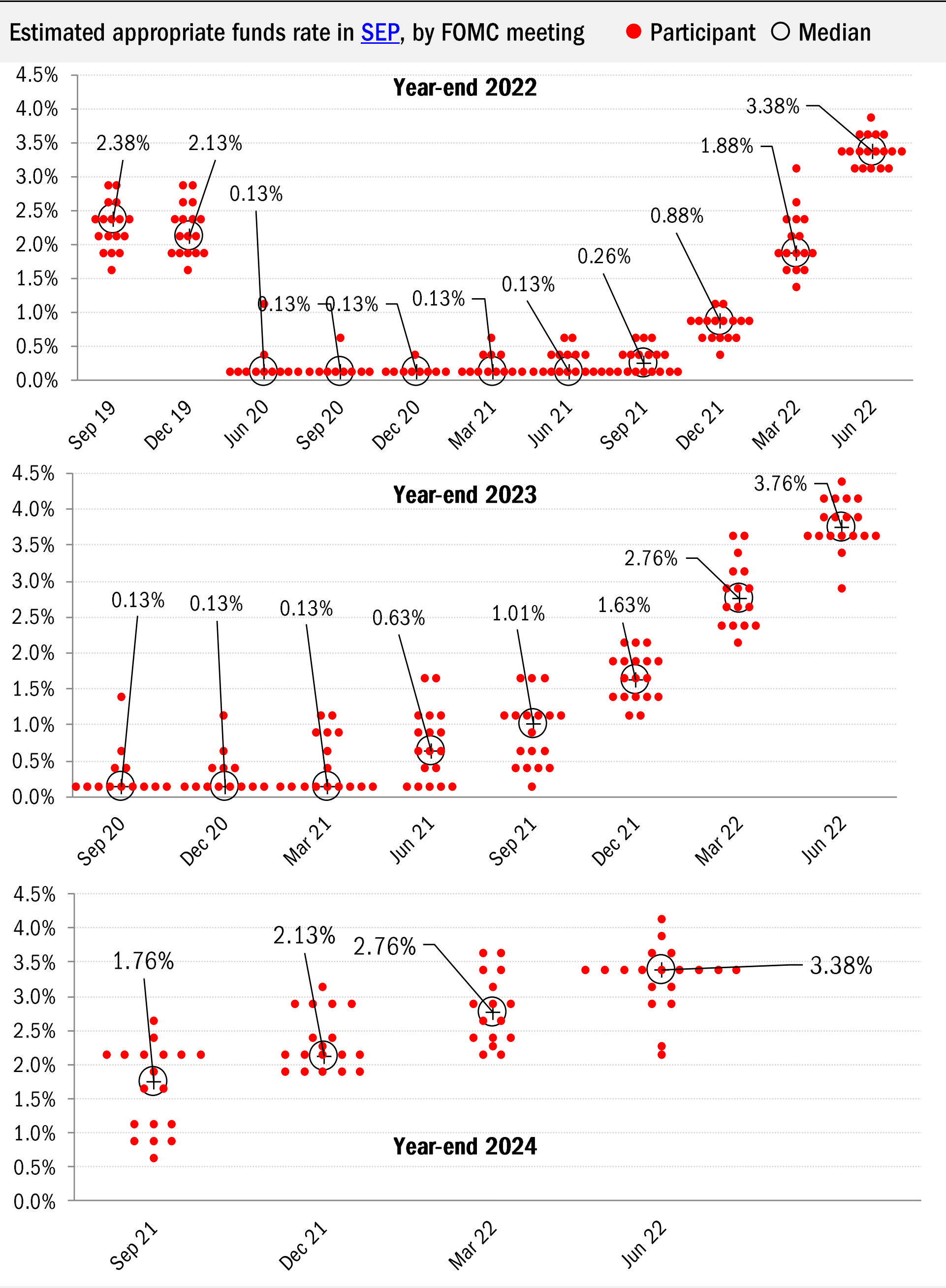
Now what does it mean? First, some historical context.

- *It's not that we've never seen a 75 bp rate hike before*. But it's been a long time. At least some of you are old enough to remember the last one in November 1994 when then-Chair Alan Greenspan raised the funds rate from 4% to 4.75%.
- *And it's not that a 75 bp rate hike hasn't been unbelievably stupid before*. Greenspan was scared that "rising levels of resource utilization" reflected in an apparently dangerously low unemployment rate of – wait for it – 5.6% made the large hike "necessary to keep inflation contained" at – wait for it – 2.7%.
- *And it's not that a stupid 75 bp rate hike has to kill the economy*. That 75 bp hike was followed by a 50 bp hike the next month. Even then unemployment ticked up slightly, to 5.8% before falling again – and by mid-year 1995 The Maestro was cutting rates. Ironically inflation had risen to 3.2% following the two big hikes designed to

lessen it. Late the following year he was giving his “irrational exuberance” speech. *Whatever*.

We’ve been saying for a long time that, with the economy well out of the depression caused by the pandemic lockdowns, it’s perfectly appropriate to normalize rates – even if there were no inflation at all (see “Video: What you're not hearing about the coming Fed tightening cycle” February 18, 2022).

- *Today’s funds rate of 1.63% is arguably pretty normal, surely no more than neutral*. It’s the rate we had before the pandemic. Even if



Source: Federal Reserve Board, TrendMacro calculations

falling rates of M2 growth are sufficient to deal with the inflation we are experiencing now, normalized Fed policy can prevent another round of inflation in the future.

- *And maybe never mind that we got back to 1.63% so quickly*. Why shouldn't we have? In March and April of 2020, we had a depression in which US GDP fell by more than 10% over just two months. The funds rate was cut from 1.63% to zero over just 18 days. GDP has gone on to make new all-time highs over a year ago – so is it such a breakneck rush to get back to a 1.63% funds rate over the last 91 days since lift-off from zero?

Be all that as it may, the key is that however surprising a 75 bp hike was for markets on Monday thanks to Powell's leak, coming into this meeting two days later it was fully discounted. It's the past. All that matters now is how it is contextualized with respect to the future.

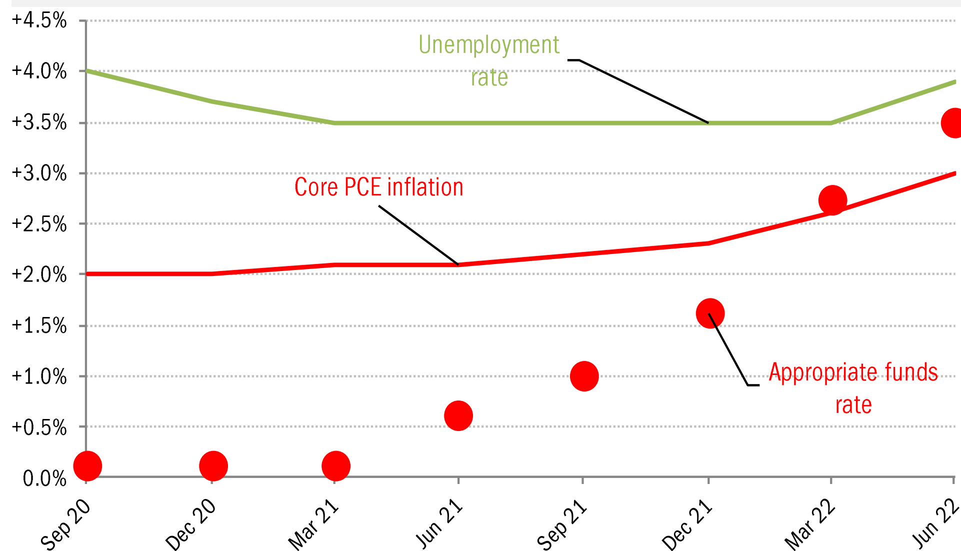
The critical elements for the future are:

- *How high will this hiking cycle go?*
- *And what will it take for Powell to see "clear and convincing evidence"?*

As to the terminal funds rate for this hiking cycle, last Friday, before the panic-inducing CPI report, markets were implying about 3%. But as of Monday markets started building in almost 4%. We can have a debate about exactly where the "neutral rate" is, but our sense is that 4% is above it.

- *The FOMC is mostly ratifying the markets on this, but not quite*. The "dot plots" in the Summary of Economic Projections of FOMC participants show an "appropriate" median funds rate of 3.38% for year-end 2022, up from 1.88% at the March FOMC SEP, and 3.76% for 2023, up from 2.76% (please see the charts on the previous page and "Data Insights: Federal Reserve" June 15, 2022). The "dot plots" imply that a new easing cycle will begin in 2024, with the funds rate at 3.38% at year end.
- That said, the SEP forecast for 2023 core PCE inflation was upgraded from 2.6% at the March FOMC to 2.7% at today's, and the unemployment rate was revised up from 3.5% to 3.9% (please see the chart on the next page). So even the new higher "appropriate" funds rate doesn't keep inflation from getting worse – yet it makes the unemployment rate worse.
- For that matter, where's the 9% funds rate it would take to satisfy the believers in the Volcker fallacy?
- Maybe at least the professional staffs that prepare the "dot plots" for FOMC participants take seriously what the committee said at the very end of the minutes of the May FOMC (again, see "Data Insights: FOMC Minutes" May 25, 2022):

  "…participants judged that risk-management considerations would be important in deliberations over time regarding the appropriate



policy stance."

- Who knew? There are considerations other than expelling the inflation object. The Fed still has two mandates.

Remember, the overarching reality here is that, under the "wave" model, inflation has already started moderating and will continue to. Powell reiterated today that such moderation will be the FOMC's single most important criterion for potentially pulling back from the stringent tightening path they are on today.

- *That means that while the reaction to Friday's data showed extremely poor impulse control on the FOMC's part, it also means that they are data dependent.*
- *We strongly believe the data will continue to improve. So the FOMC doesn't actually have to get any smarter about any of this.*

Bottom line

A 75 bp hike, and a sharp move up in the "dot plots" raising the terminal funds rate in this cycle close to 4%. Market expectations were shaped to expect this on Monday, so no negative surprise. A positive surprise is that Powell said that another 75 bp move was unlikely. The Fed has panicked, based on a fallacious understanding of inflation inflamed by an erroneous understanding of Friday's CPI data. A correct reading shows inflation already moderating over the last three months, in line with the year-ago cessation of pandemic spending programs and the corresponding moderation of M2 money growth. Powell was clear that coming inflation reports will determine the policy path. Today's new funds rate is not itself restrictive. The improving inflation data we confidently expect will keep the future path of policy from being crushingly restrictive.