

FED SHADOW

Will Powell Take Yes for an Answer?

Thursday, June 30, 2022

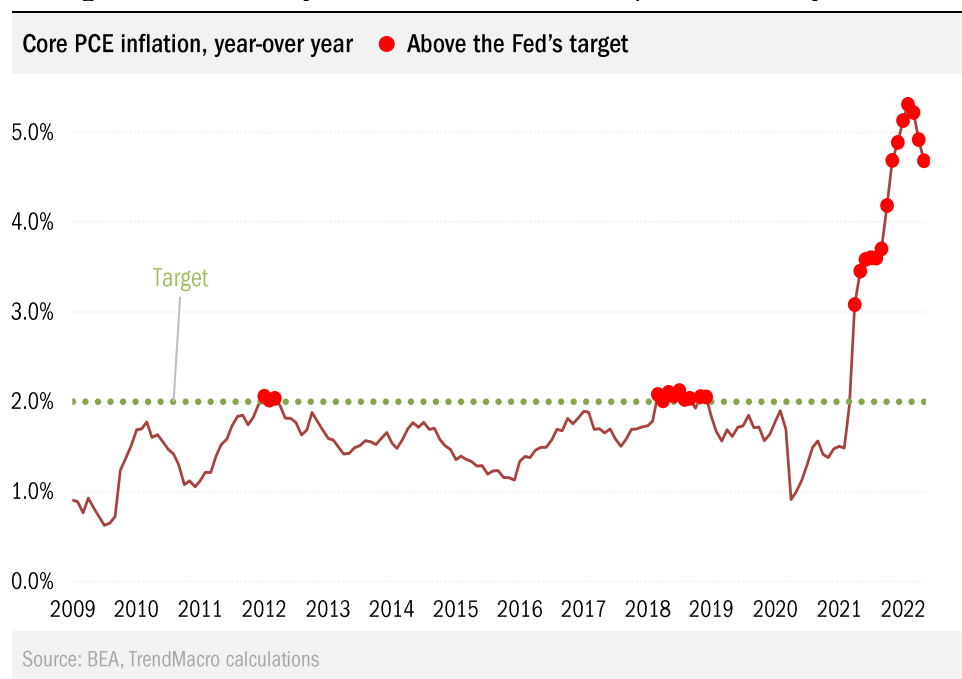
Donald Luskin

We know now we've seen peak inflation. Have we seen peak Powell?

It's official. *We've seen peak inflation*, just as our monetarist model has been predicting (see, most recently, "[Video: What you're not hearing about what Jerome Powell knows about inflation](#)" June 24, 2022). *This morning's May data for core Personal Consumption Expenditures inflation – the inflation benchmark the Fed watches most closely – came in at 4.7% year-over-year, beating the consensus estimate for 4.8%. This is the third month in a row for sequential declines since the peak in February at 5.31%. And this measure of inflation is coming down as quickly as it went up – the May reading is the lowest since October (please see the chart below).*

- *Our monetarist model predicts that this key measure of inflation will be at 1.95%, below the Fed's target, in June 2023* – based on a 13-month lag to year-over-year M2 money supply growth, which has fallen sharply from its peak in February 2021 with the cessation of new federal stimulus programs.

This good news follows on downward revisions to the University of Michigan's June survey of consumer inflation expectations. 1-year



Update to strategic view

FEDERAL RESERVE, US MACRO: May PCE inflation beat expectations this morning, with year-over-year core falling sequentially for the third month in a row to the lowest rate since last October. With downward revisions to the University of Michigan's survey of consumer inflation expectations, Powell's rationales for extreme hawkishness are evaporating. This new data confirms the validity of our monetarist model basing inflation on year-over-year M2 growth with a 13-month lag. That model now predicts core PCE will be at 1.95% in June 2023. It is not clear at all that Powell will respond to this good news. He seems stuck on a mythologized vision of Volcker as a manly inflation fighter, without seeming to understand that he was, in fact, a monetarist who followed models exactly like ours. We are positive we have seen peak inflation based on the evolving numbers, but we have no conviction that Powell will let that keep him from causing a wholly unnecessary recession.

[\[Strategy dashboard\]](#)

expectations were revised down to 5.3% from 5.4%, leaving them unchanged month-over-month, and lower than they were in April. 5-year forward consumer expectations were revised down to 3.1% from 3.3%, leaving them only 0.1% higher month-over-month, and no higher than they were in January.

- These survey numbers were initially released on June 10, the same day as May Consumer Price Index data (see [“Data Insights: CPI/PPI”](#) June 10, 2022) that was widely – and mistakenly – taken as disappointing (see [“An Open Letter to Jerome Powell”](#) June 14, 2022). Together, they triggered the following week’s panic 75 bp rate hike (see [“On the June FOMC”](#) June 15, 2022).
- In the [post-FOMC press conference](#), Fed Chair Jerome Powell specifically cited the Michigan numbers as contributing to the larger than previously planned rate hike – calling them “quite eye-catching,” as though they were a particular revelation, and a risk.
- *At the same time, he noted that “it’s a preliminary reading, it might be revised.” And now it has been. In other words, the June FOMC 75 bp rate hike was based substantially on a statistical mirage.*
- *The question is: in light of rapidly falling year-over-year core PCE inflation and quiescent expectations, will Powell revise his extreme hawkishness?*
- We think he will. And there’s another data-point that we think will help him along – the one more CPI report that will be released before the July FOMC (and then the two more that will be released before September). Our monetarist model convinces us – and this morning’s PCE data validates it – that we’ve seen peak inflation, and we have to believe that Powell will see it too and realize he doesn’t have to destroy the village in order to save it.
- But who knows? Yesterday, at the [European Central Bank’s annual conference at Sintra](#) (their version of Jackson Hole – please see the picture below), Powell said “I think we now understand better

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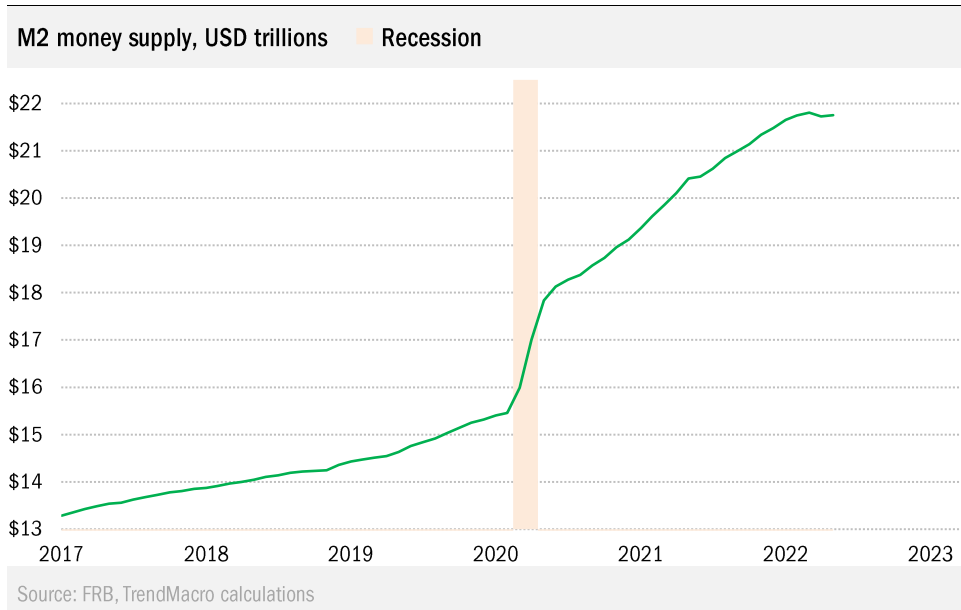
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how little we understand about inflation.”

- How nice to believe that this means his mind is open to following what we see as, and predict will continue to be, continually improving data. On the other hand, such a statement comes off as a [humblebrag](#). Who does Powell think he is, Socrates (who [famously said](#) he was the wisest man in Athens because “I know that I know nothing”)? I knew Socrates, and you, sir, are no Socrates.
- Well, we know what we don’t know. We don’t know if Powell will have the smarts to take yes for an answer on inflation.
- He compares himself frequently to former Fed Chair Paul Volcker, the larger-than-life cigar-chomping macho-man who dared to cause two back-to-back recessions in the early 1980s to reverse more than a decade of inflationary sins. What Powell doesn’t show any evidence of understanding is that Volcker was a monetarist, operating in the heyday of monetarism when Milton Friedman’s prestige and influence were at their peak.
- We lived through the Volcker era and remember it vividly and accurately. His policy framework was firmly anchored to the idea that changes in the money supply led to changes in prices – that is, inflation – so he watched the then-weekly M2 figures like a hawk (or a dove, as appropriate).



- [May M2 data](#) was released on Wednesday. M2 has stopped rising – at \$21.75 trillion, it is lower than it was two months ago (please see the chart above). Its year-over-year change peaked over a year ago in February 2022, and at 6.55% is no greater than it was in 2017. Normalizing M2 growth means that normalizing inflation is just around the corner. Volcker knew this. Does Powell? So far no evidence that he does.

Bottom line

May PCE inflation beat expectations this morning, with year-over-year core

falling sequentially for the third month in a row to the lowest rate since last October. With downward revisions to the University of Michigan's survey of consumer inflation expectations, Powell's rationales for extreme hawkishness are evaporating. This new data confirms the validity of our monetarist model basing inflation on year-over-year M2 growth with a 13-month lag. That model now predicts core PCE will be at 1.95% in June 2023. It is not clear at all that Powell will respond to this good news. He seems stuck on a mythologized vision of Volcker as a manly inflation fighter, without seeming to understand that he was, in fact, a monetarist who followed models exactly like ours. We are positive we have seen peak inflation based on the evolving numbers, but we have no conviction that Powell will let that keep him from causing a wholly unnecessary recession.

