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FED SHADOW

Walmart and the Fed

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Donald Luskin

No stimulus checks, so consumers now have to make hard choices. So does the FOMC.

Markets expect the Fed to make what we consider to be a potentially significant policy error at tomorrow's FOMC, with _*futures markets assigning a certainty of a 75 bp hike, and 13% probability of 100 bp*_.

*We continue to think that core inflation peaked in March – and that peak cannot be attributed to Fed policy*, because at that point the Fed had only just lifted off from a zero funds rate and had not yet begun running off its balance sheet.

- Instead, _*inflation peaked in March because the growth of the M2 money supply had peaked 13 months earlier*_ – the peak in money growth was transmitted into the price level with a 13-month lag (see, among many, "Why Inflation Is on the Way Down" July 25, 2022).
- Money growth has halted, and on a year-on-year basis it is back to pre-pandemic normal levels, because there have been no further Covid stimulus spending programs since the American Rescue Act in March 2021.
- Which brings us to Walmart – whose disappointing earnings announcement yesterday perfectly illustrates the principles involved. Walmart explained, "higher prices for food and fuel have hurt sales of general merchandise, especially apparel, which generate higher profit margins for the company." As a result, "it was having to cut prices."
- In other words, for the budget-constrained consumers who shop at Walmart, higher prices for gas and food left less money to buy other things, so the price of other things have to come down. _*A year earlier though, when below-median income consumers were being showered with stimulus payments, there was enough money so that no such trade-offs had to be made. The result was inflation, because high prices in some goods and services don't drive offsetting low prices in others.*_
- _*Now the stimulus payments have stopped, so tough choices have to be made – and that means inflation can revert to normal levels.*_
- That's why inflation is "always and everywhere a monetary phenomenon," as Milton Friedman famously said.
- The absence now of money growth is good news in the sense that it has already permitted inflation to peak. On the other hand, there

Update to strategic view

FEDERAL RESERVE, US MACRO: Markets fully expect a 75 bp hike at Wednesday's FOMC, and a small chance of 100. We see a small chance of only 50 bp, and the likelihood that Powell will signal future hikes will be smaller. We reiterate our call for only 25 bp in September, possibly zero. Core inflation has peaked, and Walmart's disappointing earnings show why: because with no growth now in the money supply – because there have been no stimulus programs for a year and a half – high gasoline and food prices cause consumers to cut back on other items, lowering their prices and keeping overall inflation in check. But that process is contractionary, and we now face the potential of falling into recession because of it. The dominant narrative is changing, exemplified by Warren's public warning about the human cost of pursuing what Powell admits will be an ineffectual path to higher rates.

[Strategy dashboard]

are no offsets to the growth-eroding effects of high gasoline and food prices causing consumers to make painful choices, and Walmart to experience thinner margins and lower profits.

- The accumulation of such effects is likely to have driven negative output growth for Q2-2022 – we'll find out for sure on Thursday when gross domestic product is reported out. That would be the second in a row – and while that doesn't officially define "recession," you can smell it from here.
- All that said, there is no reason whatsoever why the Fed should raise rates at all tomorrow. At 1.63%, the funds rate is already exactly where it was before the pandemic – evidently something like a normal rate. The expected 75 bp hike would take the funds rate to 2.37%, where it peaked in the prior business cycle at the disastrous December 2018 FOMC meeting, which the markets clearly and correctly judged it to be restrictive.
- *Why be restrictive at all now? Inflation has peaked. We are arguably on the brink of recession*.
- We are potentially beginning to see fault-lines developing in the narrative that has dominated the year so far, that the Fed simply must slow the economy to rein in inflation, no matter the cost. We note that after Senator Elizabeth Warren (D-MA) got Fed Chair Jerome Powell to admit to her publicly that higher rates can't bring down gasoline or food prices (see "Video: What you're not hearing about what Jerome Powell knows about inflation" June 24, 2022). An article by her underscoring the human cost of an admittedly doomed policy path appeared on, of all places, the usually hawkish editorial page of the *Wall Street Journal*. Our own op-ed on peak inflation and the central role of declining money growth appeared this morning (again, see "Why Inflation Is on the Way Down"). These are the things the FOMC participants will be reading while they sit around in the waiting room before the 2-day FOMC meeting begins today.
- So yes, markets give a small chance to a 100 bp hike tomorrow. *We give a small chance to a mere 50 bp.*
- *And we feel confident that Powell will signal in the post-FOMC press conference that future hikes will be smaller*. We are already on record saying that the hike at the September FOMC – by which time we will have seen two more CPI reports, both of which we expect to be benign – will be a mere 25 bp (see "On Inflation, If You Don't Study History…" June 13, 2022). *If there are more Walmarts, that may well be zero.*

Bottom line

Markets fully expect a 75 bp hike at Wednesday's FOMC, and a small chance of 100. We see a small chance of only 50 bp, and the likelihood that Powell will signal future hikes will be smaller. We reiterate our call for only 25 bp in September, possibly zero. Core inflation has peaked, and Walmart's disappointing earnings show why: because with no growth now in the money supply – because there have been no stimulus programs for a year and a half – high gasoline and food prices cause consumers to cut back on other items, lowering their prices and keeping overall inflation in

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