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MACROCOSM

Demand and Supply and Things Like That

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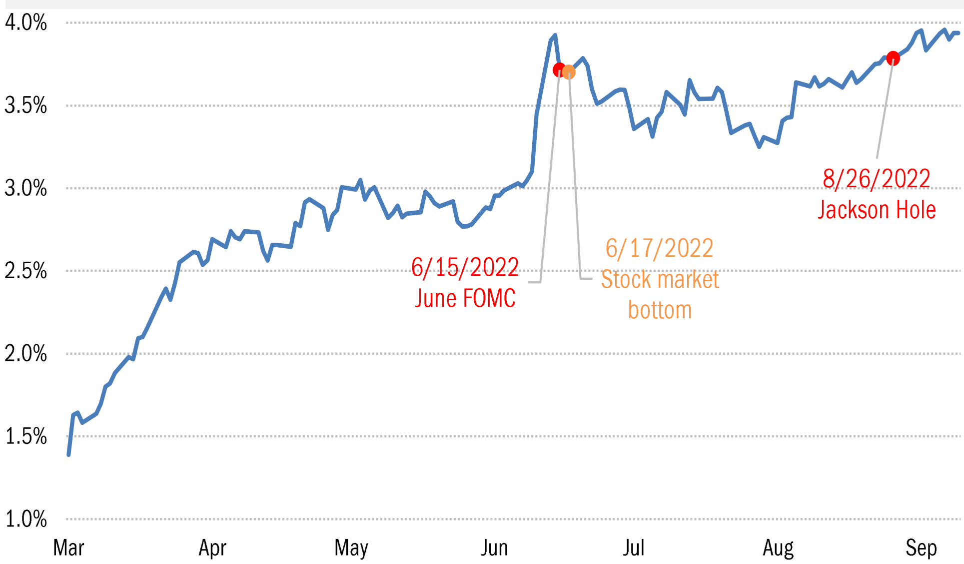
Stocks are hinting that falling inflation is going to win the death-race with recession.

There's something rather remarkable going on. The day before the June FOMC (see "On the June FOMC" June 15, 2022) the futures-implied cycle-peak funds rate was 3.92%. Now, even after Fed Chair Jerome Powell's fire-breathing performance at Jackson Hole (see "On Powell at Jackson Hole" August 26, 2022), it has not exceeded 3.96% -- basically, *Jackson Hole made no difference* (please see the chart below).

- Similarly, at 46 bp as of this writing, the futures-implied value of expected rate cuts from cycle peak through the January 2024 is virtually unchanged from June.
- While this doesn't directly point to *improving* Fed expectations as such, *expectations have gotten no worse despite rhetoric that has gotten considerably worse – and on a global basis. Yet over this same three-month period, the stock market has rallied 11.3%, as of this writing, from its bottom two days after the June FOMC* (again, please see the chart below). *So getting no worse seems to be worth something*. But why?
- *We think a worthy candidate explanation begins with the idea that the post-pandemic economy, as weird as it is in so many ways, is*

Futures-implied cycle-peak funds rate



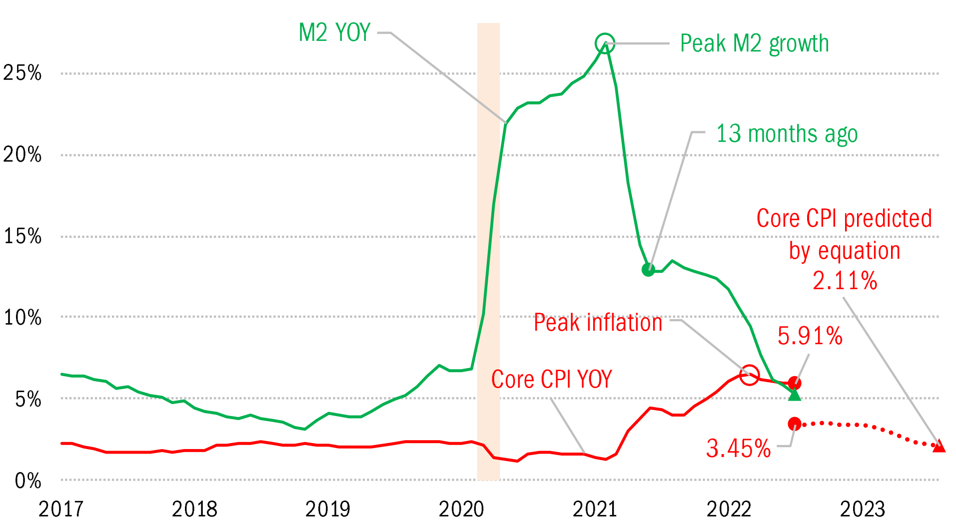
Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO, FEDERAL RESERVE: Market-implied expectations for the current Fed hiking cycle haven't gotten worse as Fed rhetoric has heated up. But they haven't gotten better since the June FOMC, either, yet stocks have rallied more than 11% from their mid-June bottom. The resolution could be that Powell needs to see either a meaningful drop in inflation or a meaningful move toward recession – it's a death-race to be the factor that ends this hiking cycle. Inflation is already falling, following the peak 19 months ago in money supply growth. And there is little evidence other than GDP that the economy is heading toward recession. The labor market is especially strong despite the Fed's tightening so far, while a huge output gap still remains. Consumer finances indicate resiliency and anti-fragility in the face of tightening financial conditions. Forward earnings fell slightly over the summer, but started growing again a month ago. The equity risk premium indicates there is little chance of recession – but if one comes, there is no value-cushion to protect equity investors.

weirdly resilient. So while the Fed seems dedicated to creating tight financial conditions that will slow the economy perhaps to the point of recession, the economy is so anti-fragile that it will take a long time for the Fed to see any results. Over that long time, despite no results, inflation will have rolled over unmistakably not because of anything the Fed has done, but simply because the surge in the money supply that created the inflation in the first place peaked 19 months ago, so inflation pressure is already dissipating, with a lag (please see the chart below, and among many, "Why Inflation Is on the Way Down" July 25, 2022).

Relation of money supply growth to Core CPI with 13-month lag — Recession



Source: Bloomberg, BLS, TrendMacro calculations

- *So Powell can honor his Jackson Hole vow to "keep at it until the job is done" because the job will be done – without anything that will deserve the official designation of recession.*
- By the way, we don't think of *that* as a "soft landing" scenario. It's not a landing at all. It's the economy brushing off a totally unnecessary hiking program because it is so resilient and anti-fragile, and not because of anything the Fed has done to make it so – while at the same time inflation rolls over, again not because the Fed did anything to cause it or to cure it.
- Powell seems to have no awareness of any of this. Yesterday at an event sponsored by the Cato Institute, the post-Chicago home of the great monetarist Milton Friedman, Powell pointedly said that there's no correlation between money growth and inflation (in reality, the correlation with a 13-month lag shows an R-squared of almost 0.90 since 2017 – see "Video: What you're not hearing about what caused today's inflation, and where it's going" June 9, 2022).
- He said that nowadays the Fed is more focused on "demand and supply and things like that." Just what other "things like that" are there? How about *money*? How about the one thing the Fed can actually do something about? Nah…

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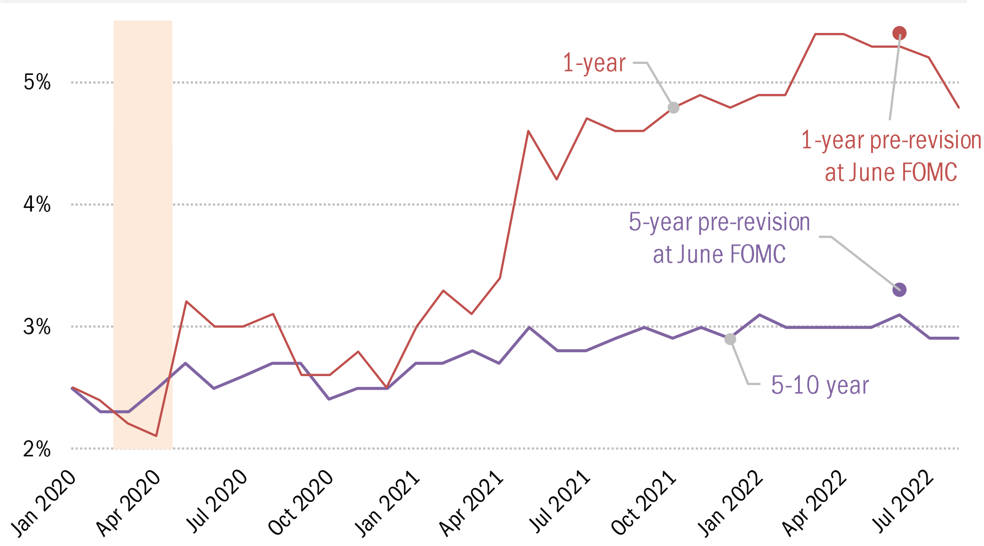
[About us]

- But it's like the great physicist Niels Bohr supposedly said when asked why he had a horseshoe nailed above his door: "I understand it's lucky whether you believe in it or not."
- What's not to believe, anyway? Core CPI peaked in March, following the February 2021 peak in M2 growth with a predictable 13-month lag (again, please see the chart on the previous page).
- On a headline basis, CPI was jolted higher in May (with the alarming data coming just three days before the June FOMC) by an 8% increase in gasoline prices (see "Data Insights: CPI/PPI" June 10, 2022). But the most recent headline CPI data, for July, showed outright deflation thanks to a 6% *drop* in gasoline prices (see "Data Insights: CPI/PPI" August 10, 2022, and "Our Hot Take on Surprisingly Cool CPI" August 10, 2022). And gasoline's 11% drop in August will do it again for sure when CPI is reported next Tuesday – *that will be two back-to-back months of deflation*.
- And just in case Powell's "things like that" *include inflation expectations, they've been coming down sharply* ever since the false alarm in the University of Michigan's survey for May (released the same day as the hot CPI report, three days before the June FOMC). Powell said the first 75 bp rate hike since 1994 was predicated, in large part, on those expectations – but they were revised away just two weeks later (please see the chart below). *Likely influenced strongly by gasoline prices, which are volatile, visible and unavoidable, survey-based expectations will continue to fall, absent some new global shock*.

University of Michigan consumer inflation expectations (median) Recession

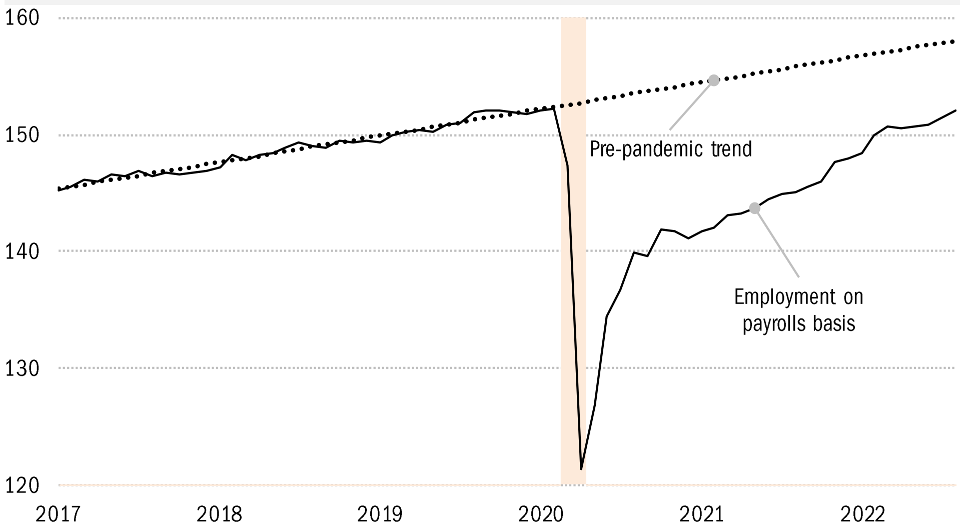


Source: University of Michigan, TrendMacro calculations

Fudd's First Law of Opposition: *if you push something hard enough it will fall over*. But "enough" is a matter of the resiliency and anti-fragility of the target – and by the time inflation rolls over, we think the Fed won't have had time to do "enough" to cause a recession. *Why do we say the economy is resilient and anti-fragile?*

- Precisely because the full hiking cycle implied in the curve today has been implied for three months, the tightening of financial conditions that is *the Fed's only tool to slow the economy has been fully deployed already for those three months. But it's sure not showing up in the labor market, the most definitive (and politically fraught) indicator of recession*.
- The worst you can say about it is that employment according to the "household survey" has been flat for four months. But payrolls in the "payroll survey" have continued to grow strongly – and it turns out that employment tabulated on a "payroll basis" has, too (please see the chart below, and "On the July Jobs Report" August 5, 2022).

US employment on a "payroll basis"

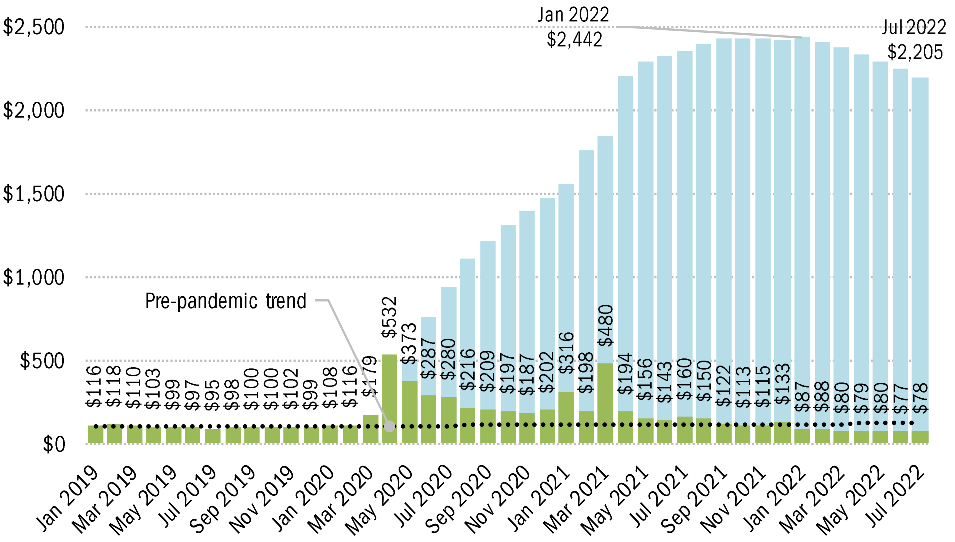


Source: Bloomberg, BLS, TrendMacro calculations

- *Yet all that strength exists only in the context of significant remaining weakness*: on a "payroll basis" employment is 6.1 million below the pre-pandemic trend (again, please see the chart above). If that were all you knew about the economy, you'd say it's in a recession already, indeed since the pandemic bottom you'd say it's never *not* been in recession.
- *A recession is nothing more complicated than the widespread underutilization of resources, and an output gap like that indicates a tremendous level of underutilization, similar to levels in past recessions*. It doesn't feel like that, because two years ago at the worst of the pandemic lockdowns it was five times worse – but that was a *depression*, not a *recession*. *The reason this is so important is that when you are 6.1 million jobs away from trend, cutting the marginal employee (when you have too few workers) is much more costly for firms than if the economy were at maximum employment (and you have enough or even too many workers)*. It's easy to cut fat, hard to cut bone. You can't fall out of the basement window. [Insert your favorite metaphor.]

- *At the same time as the Fed is trying to tighten financial conditions, US households are positioned to not feel the pinch*. Pandemic-era savings (enabled both by foregone consumption in the lockdowns and by three rounds of generous income-support programs) swelled as much as $2.4 trillion at peak in January, and are only off $237 billion since then (please see the chart below). These savings were accumulated entirely by working-class households, the mass of families who have probably never had savings like this before in their lives. Right now, the most vulnerable households are not vulnerable at all.

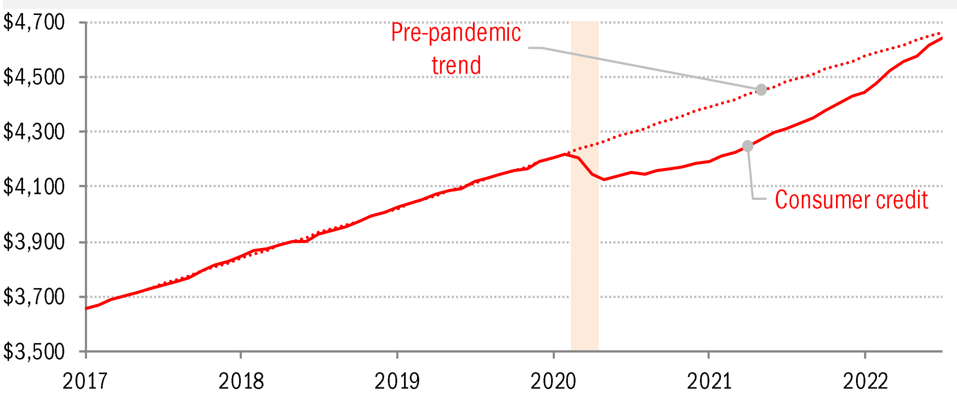
US household savings (USD billions)



Source: BEA, TrendMacro calculations

- *At the same time, consumer credit is still, after two and a half years, not even back the pre-pandemic trend* (please see the chart below).
- *These conditions are the polar opposite of the fragile state of US households in the mid-2000's before the Great Recession, when there were effectively no savings at all, when every credit card was*

US consumer credit (credit cards, personal loans, auto loans, USD billions)



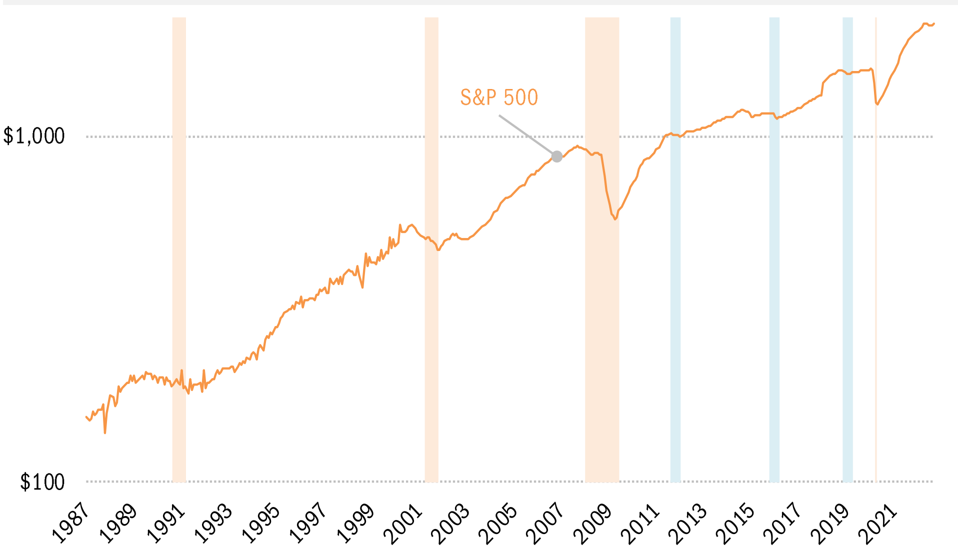
Source: FRB, TrendMacro calculations

maxed out, and when every home's equity line of credit had been exhausted.

We could frame it as a death-race – between falling inflation and a contracting economy (the winner is whichever one gets Powell's attention first, and triggers the end of this hiking cycle). *So far, falling inflation is winning – though admittedly you'd never know it from Powell's rhetoric.*

- *To be sure, it's not as though there were no signs of weakness.* US GDP has contracted for two quarters – for some observers, that's a recession. But there's so much macroeconomic evidence that contradicts it sharply. It's not just labor market data. How about the US non-manufacturing PMI released this week which, at 56.9, indicates nothing short of a boom (see "Data Insights: Global PMI" September 6, 2022).
- *And yes, the yield curve is inverted.* But it's a terrible indicator (gives you its recession signal years too early, and then always un-inverts just before the recession begins – see "Video: What you're not hearing about the flat yield curve" March 22, 2022).
- *Our favorite business cycle indicator, year-ahead bottom-up consensus S&P 500 earnings, has given us concern over the summer after it began a gentle decline from all-time highs a week after the June FOMC.*
- At the worst, about a month ago, earnings had fallen 1.9%. We saw three similar small declines during the long prior business cycle. None preceded recession, but all accompanied times of market turbulence very much like we've experienced this year (please see the chart below).
- A drop in *forward* earnings of 1.9% does not imply that one year ahead the consensus is calling for *actual* earnings to have contracted by 1.9% a year out – rather, that the expectation going

Consensus S&P 500 year-ahead forward earnings Recession Official Undocumented

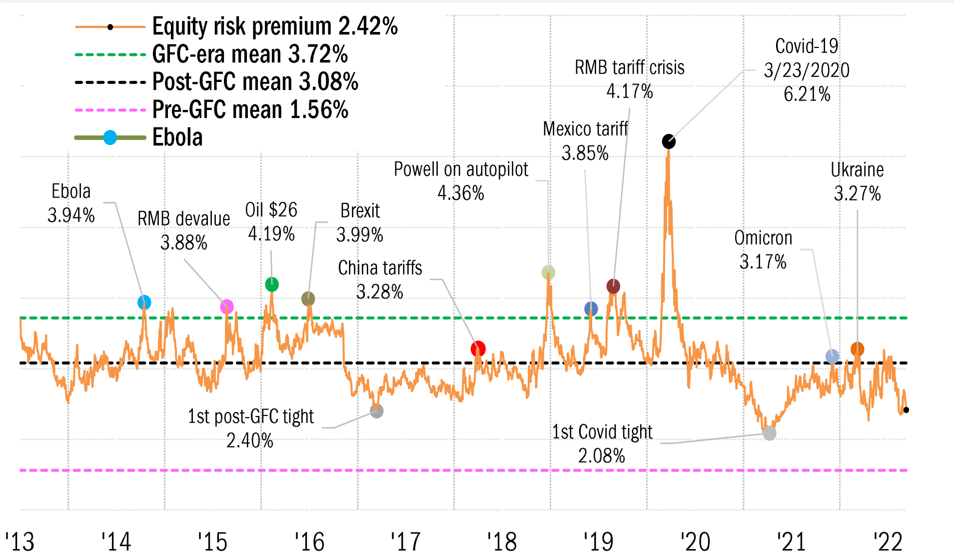


Source: Various, TrendMacro calculations in for year-over-year earnings growth at about 17% has been revised down to about 15% (not exactly a recession).

- Now, forward earnings have rebounded from their lows in mid-August by about 0.5% -- driven primarily in the out-quarters – so expected growth (according to Bloomberg) now stands at 15.9%.
- *Forward earnings never went all the way to forecasting a recession, but they were heading in that direction – and now they're heading back in the direction of goodness.*

Finally, we point out that the S&P 500 equity risk premium isn't giving us very definitive guidance here, which is perhaps appropriate given the paradoxical nature of what we've been discussing. For all the risks and uncertainties in the world, the ERP is not offering any relative-value-based incentive to buy stocks – it's below the post-global financial crisis mean, indicating that bonds are the better relative value (please see the chart below).

S&P 500 equity risk premium



Source: Various, TrendMacro calculations

- *In other words, stocks are not priced for crisis at this point.* The bad news, of course, is that there is no value-cushion here if our analysis about avoiding recession is wrong. The good news is that relative valuations are not signaling that there's as much risk in the world right now as one might well otherwise think.
- *We could say, then, that stocks are indeed betting that declining inflation will win the death-race with a Fed-induced recession. But we also have to say that there's not much of a margin of error on that.*

Bottom line

Market-implied expectations for the current Fed hiking cycle haven't gotten worse as Fed rhetoric has heated up. But they haven't gotten better since the June FOMC, either, yet stocks have rallied more than 11% from their mid-June bottom. The resolution could be that Powell needs to see either a meaningful drop in inflation or a meaningful move toward recession – it's a death-race to be the factor that ends this hiking cycle. Inflation is already falling, following the peak 19 months ago in money supply growth. And there is little evidence other than GDP that the economy is heading toward recession. The labor market is especially strong despite the Fed's tightening so far, while a huge output gap still remains. Consumer finances indicate resiliency and anti-fragility in the face of tightening financial conditions. Forward earnings fell slightly over the summer, but started growing again a month ago. The equity risk premium indicates there is little chance of recession – but if one comes, there is no value-cushion to protect equity investors.