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TRENDMACRO LIVE!

Sorry, But We're All Out of Deflation Today

Tuesday, September 13, 2022

Donald Luskin

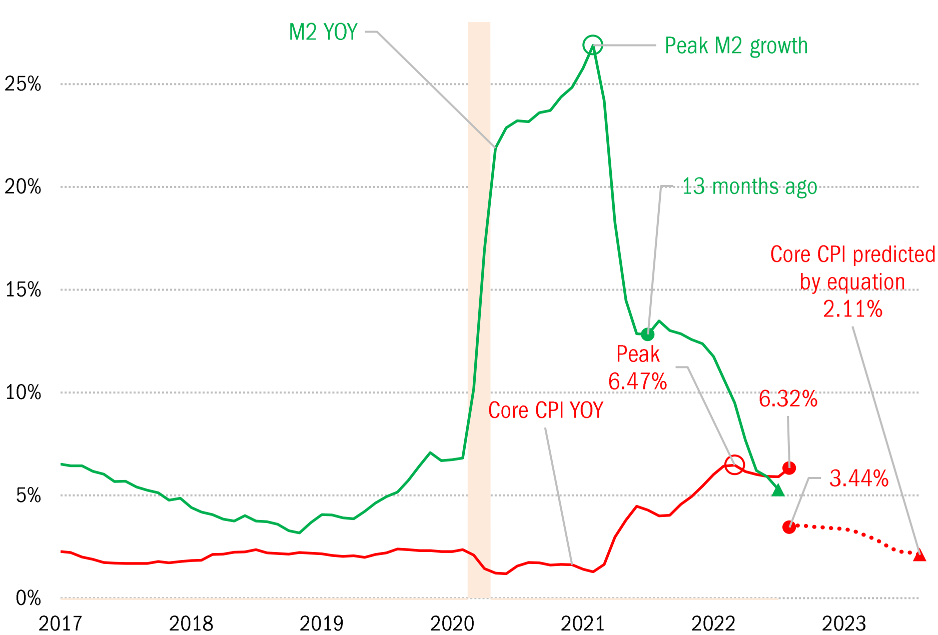
We just lost a month in the death race between receding inflation and contractionary policy.

We're surprised and disappointed that a 10.5% drop in gasoline prices in a single month, subtracting 49 bp from August's headline CPI, wasn't enough to turn the month negative overall. That's because other than public transportation subtracting 3 bp, no other irreducible category subtracted more than 1 bp (see "Data Insights: CPI/PPI" September 13, 2022). Owners equivalent rent led the positive contributors, at 16 bp.

Nevertheless, to take a positive view, *at 12 bp for the month, for a 1.4% annual rate, August headline CPI is running at about half the Fed's target expressed in CPI terms. It's not every day markets are disappointed not to see outright deflation*.

- As of this writing, futures-implied expectations for next week's FOMC have moved to a 100% probability of a 75 bp rate hike, indeed a 16% probability of a 100 bp hike. For the first time in this hiking cycle, the futures-implied cycle-peak funds rate has

Relation of M2 growth to Core CPI Recession



Source: Federal Reserve Board, BLS, TrendMacro calculations

Update to strategic view

US MACRO, FEDERAL RESERVE, FX: A big disappointment in August CPI, with gasoline the only significant deflationary component. Markets now fully expect a 75 bp hike at the September FOMC and have raised the expected cycle-peak funds rate to 4.3% at the March 2023 meeting. Strength in the trade-weighted dollar since the data release implies that markets are more worried about a hawkish shift in Fed policy than they are about inflation. Despite the disappointment, headline CPI on a year-on-year basis peaked in June and has fallen for two months sequentially, including August. Core peaked in March and fell for four months sequentially, with August being the only month in which it rose. This is consistent with the 13-month lag in our monetarist model, reflecting that the steep decline in M2 growth began to sharply decelerate exactly 13 months ago. In the death race between receding inflation and the contractionary costs of an unnecessary Fed hiking cycle, the gift of time has just been diminished by one month.

breached the 4% level, standing now at 4.3% for the March 2023 FOMC meeting (see "Demand and Supply and Things Like That" September 9, 2022).

- So it's obviously time to abandon any hope of a payoff on our outside-the-box call that the hike at the September FOMC would be no more than 50 bp, possibly even 25 bp (see, most recently, "What you're not hearing about the August jobs report: painful enough for Powell?" September 2, 2022). Well, at least it was an asymmetrical idea – that is, when the hike is 75 bp, that's no worse than what was pretty much consensus all along.
- *That said, we note that as of this writing, the trade-weighted dollar is up about 1%*. That's what you'd expect given the hawkish shift in Fed policy expectations. Or is it? When there's an upside disappointment in inflation, shouldn't that make the dollar *weaker*? *The trade-weighted dollar has to consider both inflation and the Fed's response to it. So a rally like this can only mean one thing: markets are saying that the Fed's expected policy shift will be an overshoot.*
- Sure, it's tempting to run up the white flag here and despair that inflation has metastasized and embedded across the economy, and that, at best, a downward fluctuation in gasoline prices can only mask this awful truth temporarily.
- We're not going to get in the game of obsessively parsing the numbers looking for statistical glitches (well, a bit – we'll just say we don't understand why food inflated 9.6% at an annual rate in a month in which food commodities fell 24%).
- Actually, we'll add also (we can't resist) that on a non-seasonally adjusted basis, August was in fact deflationary – headline CPI off 42 bp.
- *But our serious takeaway is that high-level reality remains: headline CPI peaked in June on a year-on-year basis and has moved lower for the two following months, including August. Core peaked in March, and moved lower for four months – August, a single month, has moved sequentially higher (still below the March peak). So are we supposed to put out the fire in our hair with an ice pick?*
- We can be sure that's what Fed Chair Jerome Powell will do. The third of the three inflation-fighting principles adduced in his Jackson Hole speech is "we must keep at it until the job is done" (see "On Powell at Jackson Hole" August 26, 2022).
- But Powell's homilies say nothing about how we will know the job is done when inflation statistics like this morning's are necessarily backward-looking, reflecting monetary policy decisions locked in months or years ago – and so, of course, any new decisions won't show up in data for months or years.
- Our way of thinking about that is to model inflation – the change in the price level – as a lagged function of past changes in the money supply. Our model shows that year-on-year core CPI lags year-on-year M2 growth by 13 months with a very high level of statistical reliability (please see the chart on the first page, and among many, "Why Inflation Is on the Way Down" July 25, 2022).
- At the risk of slicing the baloney too thin, we can't resist pointing out that *August's back-up in core CPI year-on-year, the first in five*

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months, perfectly corresponds to the sharp deceleration of the plunge in M2 growth that began exactly 13 months ago. But the fact remains that at M2 growth *now* below pre-pandemic levels, the model forecasts a drop in core CPI to below the Fed's target over the coming year – no matter what the Fed does with interest rate policy now.

- Last week we described a "death race" between receding inflation over the coming year – baked in the cake thanks to the decline in M2 growth – and the contractionary effects of Fed policy (again see "Demand and Supply and Things Like That"). It seemed to us that receding inflation was well ahead in the race, leading us to the expectation that the Fed would call off the hiking cycle sooner and at lower levels of the funds rate than markets expect.
- With this morning's CPI report, it appears that the hare has stumbled, giving the tortoise a chance. By saying that, we don't mean we don't think inflation will recede over the coming year – we are sure it will. But a race is a matter of timing. Our optimistic view of inflation just lost a month – now there's just one more CPI report due before the November FOMC. We thought we had more of a gift of time.

Bottom line

A big disappointment in August CPI, with gasoline the only significant deflationary component. Markets now fully expect a 75 bp hike at the September FOMC and have raised the expected cycle-peak funds rate to 4.3% at the March 2023 meeting. Strength in the trade-weighted dollar since the data release implies that markets are more worried about a hawkish shift in Fed policy than they are about inflation. Despite the disappointment, headline CPI on a year-on-year basis peaked in June and has fallen for two months sequentially, including August. Core peaked in March and fell for four months sequentially, with August being the only month in which it rose. This is consistent with the 13-month lag in our monetarist model, reflecting that the steep decline in M2 growth began to sharply decelerate exactly 13 months ago. In the death race between receding inflation and the contractionary costs of an unnecessary Fed hiking cycle, the gift of time has just been diminished by one month.