Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Or How I Learned To Love September CPI

Thursday, October 13, 2022

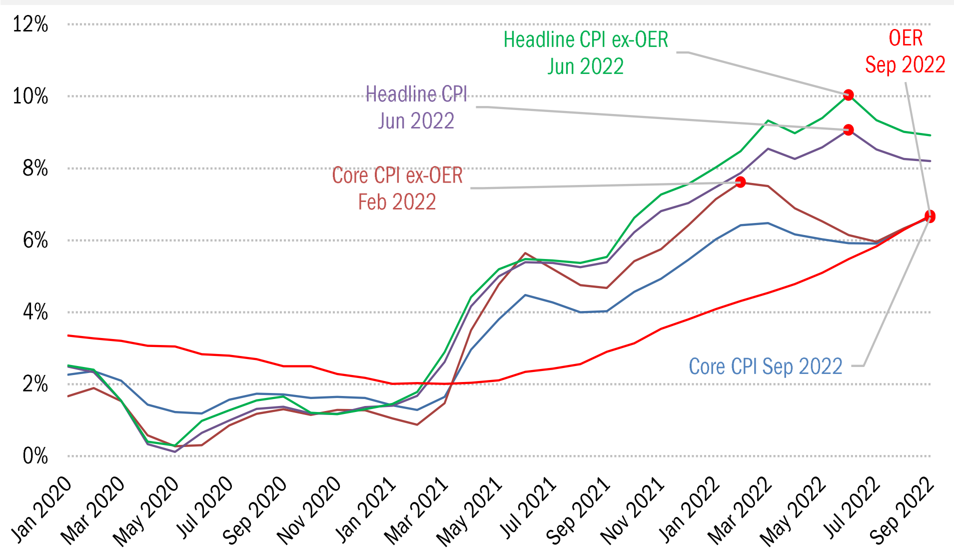
Donald Luskin

By most measures, the reality remains that inflation has peaked. The Fed likely doesn't care.

This morning's September Consumer Price Index report notched a new high in year-on-year core at 6.6%.

- Let us say at the outset that *this confounds the prediction of our monetarist model based on changes in the M2 money supply* (see, among many, "Video: What you're not hearing about what caused today's inflation, and where it's going" June 9, 2022). The model had expected the March high at 6.47% to hold.
- The model assumes a 13-month lag between year-on-year M2 growth and year-on-year core CPI growth. It so happens that 13 months ago there was a jump in year-on-year M2 growth, and that corresponds with this morning's jump in inflation. But that's a trivial factor – the overriding issue is that M2 growth has slowed substantially from its February 2022 peak, and month-to-month flutters notwithstanding, core CPI should not be making a new high, yet it is.
- So *should we throw our model on the trash heap?*
- *No*. While we've always expressed great confidence in it, we've also said it's *only* a regression equation, and its very high

Year-on-year inflation ● Cycle peak



Source: BLS, TrendMacro calculations

Update to strategic view

US MACRO, FEDERAL RESERVE, EUROPE MACRO: Our monetarist model of core CPI based on M2 money supply growth was confounded by a new year-on-year high in September's report this morning. The culprit is owners' equivalent rate, the removal of which sets the peak in February. Removal makes no difference to headline CPI, which peaked in June. OER is the largest and laggiest component, and while it is an important reality to acknowledge, removing it gives analytic clarity on underlying inflation processes. So we continue to believe firmly that inflation has peaked. But the Fed is making it increasingly clear that it doesn't care either way, and will continue to tighten regardless of incoming data. Hiking regimes continue until "something breaks." Something is breaking in the UK, with the crisis in its pension sector. It is no coincidence that the Bank of England was the first central bank to lift off from pandemic-era low rates, three months before the Fed did.

[Strategy dashboard]

coefficient of determination of 0.9 leaves room for error versus the ideal 1.0.

- *We 100% stand by the model's underlying logic that, as Milton Friedman said, "inflation is always and everywhere a monetary phenomenon" – and with the cessation of $6 trillion in Covid stimulus, the sharply falling rate of money growth will lead to a concomitant decline in the rate of inflation. It's just a question of what Friedman called "lags that are long and variable." The outcome really isn't in doubt.*
- *Of course, the issue for the moment is the effect of CPI of OER – owners' equivalent rent, the largest single contributor to the hot numbers reported this morning* (see "Data Insights: CPI/PPI" October 13, 2022). OER is the largest single component of CPI, which is used by the Bureau of Labor Statistics as a proxy for home prices. Throughout the present inflationary episode, even before we introduced our model, clients frequently grilled us about its long-lasting effects. The argument is that money growth affects home prices with a lag, and then home prices affect rents with another lag. So inflation statistics will continue to run hot long after the root causes of overall inflation have become inactive.
- We've never questioned the validity of that concern as a computational matter. We have understood that OER is potentially a confounding variable in our model. It's a wild card – the largest component in CPI (even larger in Core CPI), and also the most laggy. And wouldn't you know it – in the post-pandemic era, the home prices that drive OER have seen the highest year-on-year gains in history.
- *All that said, the path of year-on-year CPI doesn't look much different with or without OER – either way, the peak year-on-year was in June* (please see the chart on the first page).
- *But the path for core CPI (in which OER is even a larger component) looks quite different, depending on whether OER is included. With it, today's September reading is the year-on-year peak, and without it the peak was February* (again, please see the chart on the first page).
- *In other words, our M2-based model proves out in all measurements except core CPI including OER.* To be sure, core CPI has always been the thing we have said the model is trying to predict, so we deserve any criticism you want to level at us. But if what we're ultimately trying to get at here is some idea of the true trend of inflation as an overall force in the economy – abstracted from any one of the many ways of looking at it – *we think the model is still on track, and it is still telling us that inflation has peaked and is destined to head lower*.
- After all, we've seen the peak in headline CPI that includes all items, whether or not we leave OER in the mix. If it makes sense to look at core in order to exclude the most volatile and noisy items – energy and food – then it arguably also makes sense to exclude the most laggy item, OER, and when you do, again we've seen the peak.
- *Would it be too presumptuous or premature to say markets agree with us? As of this writing mid-day Thursday, US stocks have more*

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Dallas TX
214 550 2121
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

than recovered all their steep losses sustained when the CPI report hit the wires.

That said, everything we've argued so far is to some extent irrelevant, because it deals with only one of two realities. Even if you accept our arguments, all we've done is nerd out on the reality of inflation *itself*. *We haven't even mentioned the second reality – the Fed*.

- We can be pretty sure that if this morning's CPI had been a beat rather than a miss, it wouldn't have made any difference to the Fed. This key passage from yesterday's minutes of the September FOMC meeting can be summed up to mean "don't confuse us with the facts" (see "Data Insights: FOMC Minutes" October 12, 2022).

  "Many participants emphasized that the cost of taking too little action to bring down inflation likely outweighed the cost of taking too much action. Several participants underlined the need to maintain a restrictive stance for as long as necessary, with a couple of these participants stressing that historical experience demonstrated the danger of prematurely ending periods of tight monetary policy designed to bring down inflation."

- What could stop them?
- A piece of folk wisdom about central banking has been making the rounds: *tightening cycles end when something breaks*. It's true in the sense that something breaking – that is, some indicator of emerging systemic risk – is *sufficient* to end a tightening cycle (but it's not *necessary*; many cycles have ended without it).
- So far nothing is breaking in the US economy, other than a big correction in stocks (see, for example, "On the September Jobs Report: Dear God, What Does Powell Want?" October 7, 2022).
- So, as we've said repeatedly, we're in a death race between the "weirdly resilient" economy – especially the labor market, the supposed tightness of which the Fed continues to hallucinate is the true cause of inflation – and enough cooling of reported inflation to finally get the Fed's respect.
- *But things are breaking elsewhere – and it's especially important to note exactly where they are breaking.*
- The United Kingdom continues to flail in the throes of a crisis in its pension sector, a vicious cycle in which rising bond yields generate margin calls in levered Liability-Driven Investment strategies, which require selling bonds and driving yields higher still. It's a version of what happened to US pensions on October 19, 1987, thanks to similar positive-feedback loop effects arising from so-called Portfolio Insurance.
- We have no doubt that the necessary precondition for that vortex has been the Bank of England's long-standing rate-hiking regime (see "It's Starting to Feel a Lot Like Brexit" September 28, 2022). It was undertaken in a clinically insane delusion that sharply rising energy prices – driven by decades of misguided green policies and exacerbated by the Russian invasion of Ukraine (see "Video: A

conversation with Dr. John Constable on the energy crisis facing Europe" October 6, 2022) – are driving inflation. The starter's pistol for the current panic was surely the BoE's announcement that it would soon commence outright sale of bonds from its portfolio, rather than let them mature off as the Fed is doing.

- We're encouraged that the BoE has had to back off this suicidal path by buying bonds to support panicking pensions. To save face, they call it an "intervention" and have put a deadline on it (we'll see if that lasts…). But when you say you are going to sell bonds and then you buy them, that's a policy reversal and we're thrilled to see it.
- *We rehearse all these facts about the BoE because it may prove to be no coincidence that things are starting to break first in the UK, because the UK was the first central bank among developed economies to lift-off from pandemic-era low policy rates. The BoE hiked in December 2021, and the Fed didn't lift off until March 2022.*
- Does this mean that something will break in the US in three months? Perhaps – but we have no idea what it would be, considering the labor markets, household sector and banking sector are in historically strong positions. But then again if you'd asked us a month ago whether the UK pension sector would blow up, well, we'd have had no idea.

Bottom line

Our monetarist model of core CPI based on M2 money supply growth was confounded by a new year-on-year high in September's report this morning. The culprit is owners' equivalent rate, the removal of which sets the peak in February. Removal makes no difference to headline CPI, which peaked in June. OER is the largest and laggiest component, and while it is an important reality to acknowledge, removing it gives analytic clarity on underlying inflation processes. So we continue to believe firmly that inflation has peaked. But the Fed is making it increasingly clear that it doesn't care either way, and will continue to tighten regardless of incoming data. Hiking regimes continue until "something breaks." Something is breaking in the UK, with the crisis in its pension sector. It is no coincidence that the Bank of England was the first central bank to lift off from pandemic-era low rates, three months before the Fed did.