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MARKET CALLS

Surprises of 2023 Volume 1: From Inflation to Deflation

Tuesday, January 3, 2023
Donald Luskin

Few expect inflation at-target by summer. No one expects outright deflation.

CPI AT TARGET BY SUMMER
Probability: **85%**
Consensus: **25%**

FED ONE-AND-DONE
Probability: **70%**
Consensus: **20%**

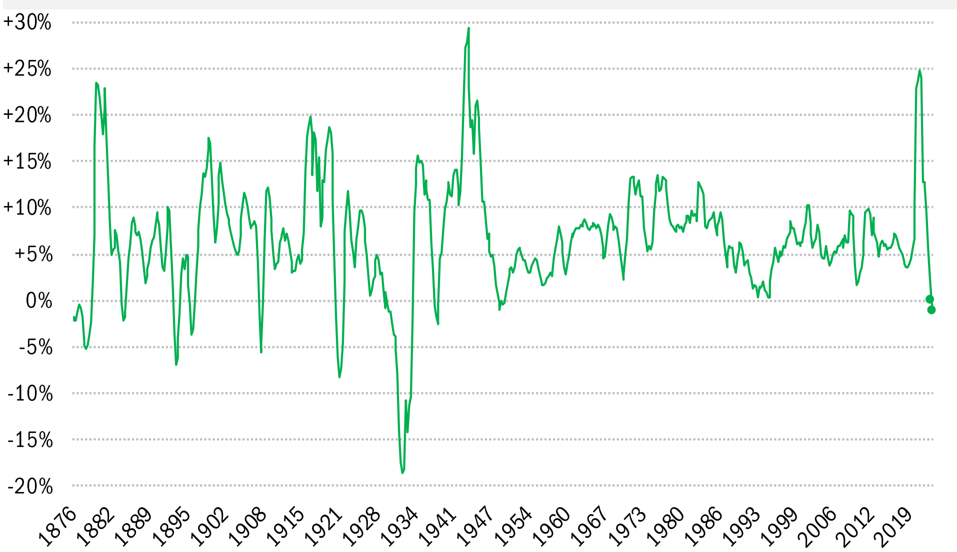
DEFLATION BY YEAR-END
Probability: **65%**
Consensus: **10%**

Based on our monetarist model, we continue to expect that *US inflation has peaked, and will fully return to the Fed's target by summer* (see "Why Inflation Is on the Way Down" July 25, 2022).

In client conversations, the consensus doesn't dispute that inflation has peaked, but only a minority agree with us that the Fed's target will be attained so quickly. But if it is, then *given that the Fed has slowed the pace of rate hikes, it is likely to stop altogether, and at a terminal rate lower than now expected, avoiding a rate prohibitive enough to cause a recession* (see "On Powell at Brookings" November 30, 2022).

But what's completely out of consensus is the probability that the next step is deflation. The M2 money supply has been shrinking at an annual rate of

M2 money supply (YOY, quarterly; last two data points extrapolated from rate since peak)



Source: 1876-1958 NBER, 1959-present Federal Reserve, TrendMacro calculations

Update to strategic view

US MACRO, FEDERAL RESERVE, US BONDS, US STOCKS: The money supply is contracting, and at this rate will go negative year-on-year in four months. That points to at-target inflation rates by summer, continuing to fall until they reach outright deflation in early 2024. A 25 bp hike is locked in for February, but with two more CPI reports before the March FOMC, February is likely to be the final hike, in which case recession will not be inevitable. In March the Fed will take credit for the disinflation baked in the cake a year ago before they even lifted off, and will warn markets of a long plateau at a restrictive level. But as inflation continues to fall, the first cut will likely come at the June FOMC. This is significantly out of consensus, and will be very bullish for both stocks and bonds. There will be uncertainty when deflation appears, and much will depend on how the Fed reacts to it. Rate cuts are likely to accelerate, and QT is likely to end. If the Fed fails to react, there would be a different recession than the one now feared – one based not on tightening, but on failing to ease.

2.7% for the eight months since its peak in March. That's the longest period of contraction since the seven-month contraction in 1994.

- By the way, 1994 was the last time there was a 75 bp rate hike. M2 growth didn't go outright negative then on a year-over-year basis, and it hasn't so far this time. But if it goes on for four more months, it will be the first year-over-year contraction since 1949 (please see the chart on the previous page).
- *<u>If that happens, then according to our model, CPI will be at just 0.69% at year-end. And if the trend continues, it will go negative in April 2024. Long before then the narrative will have flipped from fear of inflation to fear of deflation.</u>*
- There will be one CPI report before the next FOMC meeting on February 1. We expect it will be a very benign one, but the Fed is probably too institutionally committed at this point to not hike the funds rate by the minimum 25 bp.
- But then there will be two more CPI reports before the March 22 meeting. They will be benign too, and according to our model, the FOMC will have in hand a 4.2% year-over-year CPI reading (or 3.1% ex-owners' equivalent rent, which is how they are thinking about it now – again, see "On Powell at Brookings").
- Given our model's assumption of a 13-month lag from M2 growth to inflation, at the March FOMC it will be out of the question to think that the Fed's having lifted off from a zero funds rate 12 months earlier will have played any role at all in this inflation result. It will simply be a function of the decline in M2 growth, which will have been a function of the cessation of pandemic stimulus spending two years prior.
- *<u>Nevertheless, we think the Fed will take credit for it, giving it a rhetorical foundation on which to justify no more hikes. Chair Jerome Powell will emphasize that the then-current funds rate of 4-5/8% is restrictive, and will suggest it will plateau there "longer than expected."</u>*
- *<u>Whatever. Just words. February's hike is likely to be the last in the cycle. From here, one-and-done. The first cut will come in June.</u>*
- And despite the likely rhetoric, the funds rate won't stay at 4-5/8% for long, as inflation continues to collapse, and the narrative turns from inflation to deflation.

Would negative year-on-year money supply growth in and of itself cause a recession?

- Hard to say – there is no precedent since the five quarters of negative money growth from Q1-1948 to Q4-1949. That episode was associated with price deflation, and with a deep recession. But that post-World War Two epoch was even more extraordinary than our post-pandemic one. And the data methods are not comparable.
- In 1994, the previous modern episode of any money supply contraction at all – though it never went negative on a year-on-year basis – there was not a notable change in the rate of inflation, nor was there a recession.

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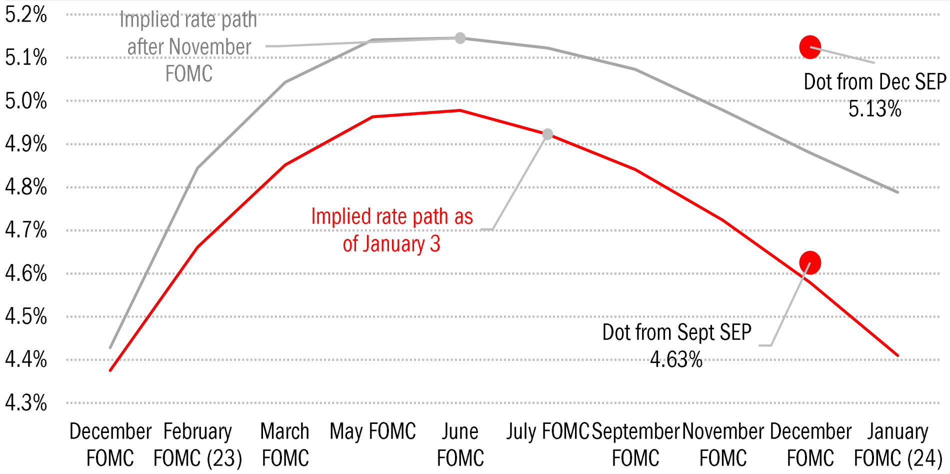
- *For now, a recession is not baked in, and an end to this hiking cycle in February means the Fed will not trigger a recession with further hikes*.
- The money-market curve is already laughing out loud at the Fed's "dot" for the year-end funds rate at 5-1/8% (please see the chart below, and ["Video: What you're not hearing about the day the market stopped believing the Fed"]() December 19, 2022). And the curve anticipates an end to this hiking cycle this year. But there's a world of difference between the curve's call for an end at the June FOMC, with a funds rate of about 5%, and ours for the February FOMC with a funds rate of 4-5/8%. The curve sees some small chance of a cut at the July FOMC. We think it will be 25 bp in June.

Futures-implied funds rate, by FOMC meeting



Source: Bloomberg, TrendMacro calculations

- *If we're right, this will be a meaningful upside surprise for both stocks and bonds.*
- *But when the narrative turns to deflation later in the year – which pretty much no one is expecting – there will be some buffeting while markets figure out whether it's a good thing or a bad thing (which will depend very much on what the Fed has to say about it).*
- *Rate cuts could accelerate, and the normalization of the Fed's balance sheet – so-called "quantitative tightening" – could suddenly cease.*
- It wouldn't be Powell's first hard U-turn. Or even his second.
- *If the Fed doesn't react that way, then there could indeed be a recession – not the one markets fear now because the Fed is tightening, but a whole different one because the Fed isn't easing.*

Bottom line

The money supply is contracting, and at this rate will go negative year-on-year in four months. That points to at-target inflation rates by summer, continuing to fall until they reach outright deflation in early 2024. A 25 bp hike is locked in for February, but with two more CPI reports before the March FOMC, February is likely to be the final hike, in which case recession will not be inevitable. In March the Fed will take credit for the disinflation baked in the cake a year ago before they even lifted off, and will warn markets of a long plateau at a restrictive level. But as inflation continues to fall, the first cut will likely come at the June FOMC. This is significantly out of consensus, and will be very bullish for both stocks and bonds. There will be uncertainty when deflation appears, and much will depend on how the Fed reacts to it. Rate cuts are likely to accelerate, and QT is likely to end. If the Fed fails to react, there would be a different recession than the one now feared – one based not on tightening, but on failing to ease.