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TRENDMACRO LIVE!

# On Powell at the Washington Economic Club

Tuesday, February 7, 2023

**Donald Luskin**

**Unless his goal is to create confusion, he's really not very good at this Fed chair thing.**

How do we count the ways?

1. By almost any measure, *inflation has peaked and is heading lower* (see "On November CPI – Inflation Definitively Peaks" December 13, 2022). The FOMC acknowledged as much at last week's meeting by amending the statement to say "inflation has eased somewhat" (see "On the February FOMC" February 1, 2023).
2. *Friday's jobs report was a weird anomaly* in which the 517,000 net payroll gains were as much as six times any competing contemporaneous measure, and completely out of pattern with the consistently declining payroll gains seen in the prior months (see "On the January Jobs Report, and US Services PMI" February 3, 2023).
3. Even taken at face value, *those payroll gains are not evidence that the labor market is excessively tight*. Quite the contrary – only a very loose labor market can produce that many jobs gains (if it were tight, the gains would be about 90,000, the number of people who become newly eligible to work each month).
4. *Tight labor market conditions*, even if they existed (which they don't) *have no historical relationship with inflation* (see "Video: What you're not hearing about services inflation and the 'over-tight' labor market" August 16, 2022). That should be obvious from first principles, considering that workers are both demanders and suppliers (so throwing them out of work may lower price pressures from consumer demand, but creates countervailing price pressures from scarcity of supply when those same workers can no longer produce).
5. *The money supply has contracted year-over-year* for the first time in the history of the data (see "Surprises of 2023 Volume 1: From Inflation to Deflation" January 3, 2023). Unlike labor market conditions, changes in the money supply have shown a strong historical correlation with inflation, a nearly perfect one since the pandemic. But Powell didn't even mention it at last week's FOMC. This points unerringly to an acceleration in the moderation of inflation, and indeed points to outright deflation.

After last week's FOMC – with the acknowledgment that "inflation has eased" and the commitment to consider the "extent" of future hikes in the context of lags between policy and outcomes – *markets were right to*

**Update to strategic view**

**FEDERAL RESERVE, US MACRO:** In a colloquium today Powell ratified the market's whipsaw reversal of expectations for the path of the funds rate following Friday's payroll report, adding a rate hike and taking away one-and-a-half cuts. He acknowledges that disinflation is underway without any weakening of the labor market, and yet clings to a policy framework holding that a strong labor market causes inflation. He remains silent on the year-over-year contraction in the money supply and its implications for outright deflation. His policy framework is confused, and he seems to welcome the confusion this causes for markets, keeping financial conditions tight. There will be two weak CPI reports and one less-strong jobs report before the March FOMC. It's a tough call, but we still say last week's rate hike was the last one.

[Strategy dashboard]

*impound expectations that there would be at most one more rate hike, and that there would be as many as three cuts over the coming year*.

Then as soon as the jobs report came out Friday morning, market *expectations snapped right back to where they were all the way last November – with two hikes expected, followed by one-and-a-half cuts*.

Seriously? One jobs report does that? One jobs report that is clearly an anomaly? One jobs report when jobs don't have anything to do with inflation?

Yes – and indeed Fed Chair Jerome Powell said today in a colloquium at the Economic Club of Washington that "financial conditions are more well-aligned than they were before."

Yet he also said "it's a good thing that disinflation is underway without seeing the labor market weaken." *So he sees the real world right-here right-now evidence of the fallaciousness of his theory that a strong labor market causes inflation – and yet he clings to it.*

Is he just confused? Or *is his goal to keep markets confused – and thereby keep financial conditions tight?* Both.

Fortunately there are two more CPI reports and one more jobs report before the next FOMC in March. We are confident that those CPI reports will be very weak, with headline month-on-month deflation baked in the cake for January. And there's no way payrolls repeat last week's upside anomaly. It's getting harder to think last week's hike was the last one, but we still do.

**Bottom line**

In a colloquium today Powell ratified the market's whipsaw reversal of expectations for the path of the funds rate following Friday's payroll report, adding a rate hike and taking away one-and-a-half cuts. He acknowledges that disinflation is underway without any weakening of the labor market, and yet clings to a policy framework holding that a strong labor market causes inflation. He remains silent on the year-over-year contraction in the money supply and its implications for outright deflation. His policy framework is confused, and he seems to welcome the confusion this causes for markets, keeping financial conditions tight. There will be two weak CPI reports and one less-strong jobs report before the March FOMC. It's a tough call, but we still say last week's rate hike was the last one.

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