Trend Macro™

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

FED SHADOW

Good News is Bad News is Equilibrium

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Donald Luskin

It's like The Three Little Pigs: Powell is a weak wolf, and the economy is a house of brick.

Yesterday's retail sales report, showing January growth of 3%, was one in a string of blockbuster macroeconomic data this month (see "Data Insights: Supply Chain Stress Monitor" February 15, 2023). That report can be nit-picked and fact-checked to death, as we have indeed done with the equally strong January jobs report with 517,000 net payrolls and January PMI non-manufacturing index at 55.2, and the retail sales number (see "On the January Jobs Report, and US Services PMI" February 3, 2023). *But even if all three are only a fraction as good as they seem, they are still good. If the recession the Fed is trying to engineer were upon is, they'd be bad*.

The usual narrative is that good news is bad news – because the stronger the economy is, the harder the Fed will have to whack it. But that is an overused cliché that doesn't have to be true.

- To be sure, since the day before the jobs report, market-implied expectations for the path of the funds rate have steepened sharply, to the worst levels since this tightening cycle began (please see the chart below).
- *Before the January jobs report*, the market-implied peak funds rate was 4-7/8% – not to be reached until the May meeting, pointing to

Update to strategic view

US MACRO, FEDERAL RESERVE, US STOCKS: Surprisingly strong jobs, PMI, retail sales – and CPI – data have driven the market-implied path of the funds rate to new cycle highs, now showing two-and-a-half rate hikes by summer, and only one rate cut by next January. The old "good news is bad news" cliché doesn't capture the dynamic though: this is an equilibrium in which, while the funds rate is higher, the economy is no more vulnerable than it was before because it has gotten stronger at the …

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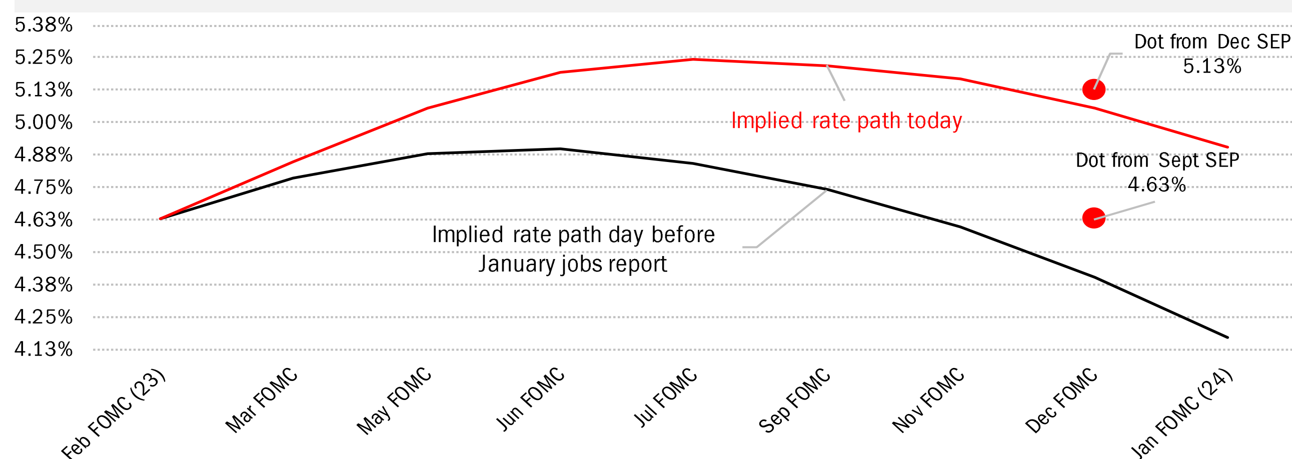

Source: Bloomberg, TrendMacro calculations

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no hike in March. Then by January 2024, the rate would fall to 4-1/8% – pointing to three rate cuts, and a lower rate than today's by 50 bp. The first cut would come in either September or November.

- *But now, after the January jobs report, January PMIs and January retail sales*, the market is implying a 25 bp hike in March and two more – or possibly three – across May, June and July, bringing the funds rate to a cycle peak of 5-1/4%. The first cut would come in December, with maybe another in January – at which point the funds rate would be 25 bp higher than we have now (again, please see the chart on the previous page).

But why is that bad news? If the January data means the economy is stronger than previously thought, and now the terminal funds rate is also higher than we previously thought, then nothing has changed in principle. It's neither good news nor bad news. It's no news. It's equilibrium.

- To digress for a moment to a more secular view, this evolving equilibrium may be the *departure from the post-Great Financial Crisis "new normal" back to an "old normal,"* one with higher economic growth rates, inflation not persistently below the Fed's target, higher policy rates and higher long-term yields. That would seem to be what the US equity risk premium is telling us, having as of yesterday reverted to within a mere 5 bp of its pre-GFC mean, at a level not seen since 2007 (please see the chart below, and see "Equity Risk Premium: Regime Change Accomplished" October 25, 2022).

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… same time. This may point to a return to a pre-GFC "old normal," as implied by the S&P 500 equity risk premium having mean-reverted to 2007 levels. Recessions require both a shock and vulnerability to shock. The implied funds path is a mild shock, and the economy is very shock-resistant. We rule out a hard landing.

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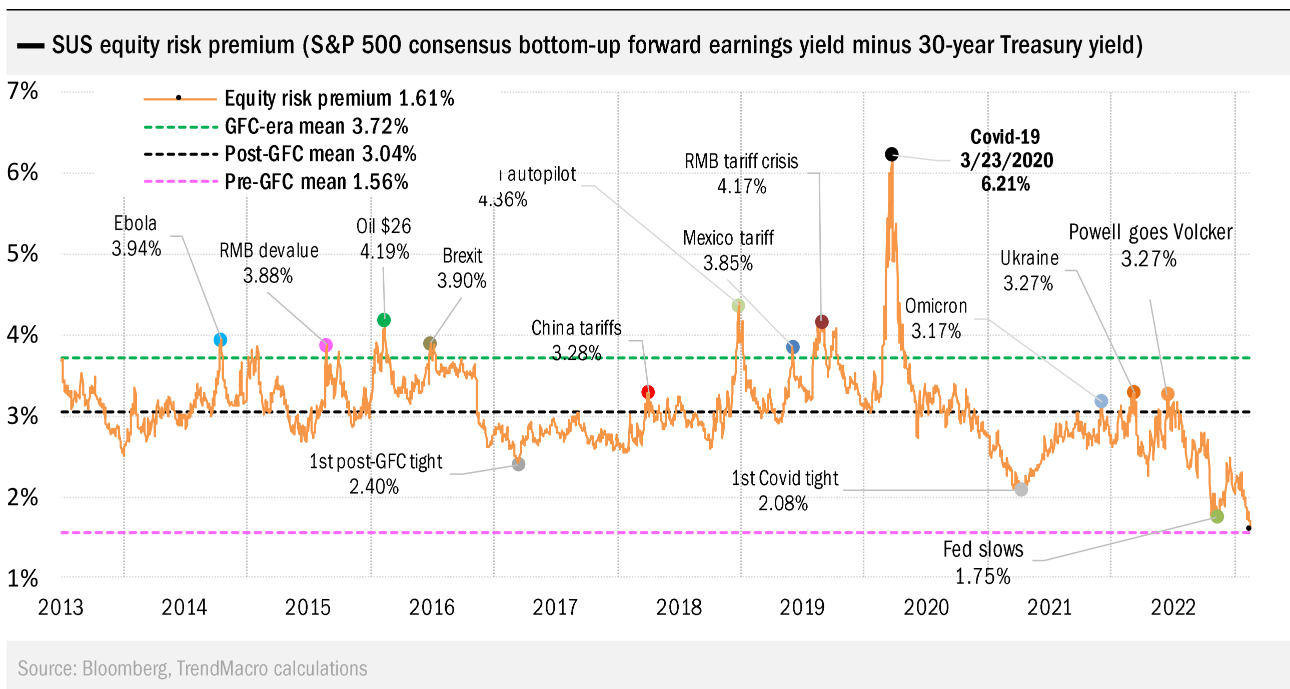

Source: Bloomberg, TrendMacro calculations

Back to the immediate context, think about it in terms of the idea of a "restrictive rate" for fed funds. Fed spokespeople use that term all the time, but they never really define it. Presumably it's something like: a rate that holds economic growth at zero. That is, it doesn't cause a recession, but it

stops growth. A rate sufficiently above the restrictive rate would cause a recession.

No one knows what level of the funds rate is restrictive at any moment in time – but our point about equilibrium is that when the economy is stronger it takes a higher rate to restrict it than when it is weaker, just as it takes a stronger cage to contain a tiger than to contain a bunny. The January data suggests that the economy is a tiger. It will take a higher funds rate to contain it (and an ever higher one to kill it).

- We're not saying there isn't some hypothetical funds rate that could cause a recession. But the evidence is that the present 4-5/8% isn't it, even after having gotten there with a series of four unprecedented back-to-back 75 bp hikes and the most hawkish fed-speak in memory.
- In fact, the economy accelerated throughout last year – starting 2022 with two quarters of GDP contraction in Q1 and Q2 before the Fed had even started hiking in earnest. When the Fed's scorched-earth policy of 75 bp rate hikes began in mid-June, against all intuition that seems to have set the stage for the strong GDP growth in Q3 and Q4 taking US output to new all-time highs (see "Video: What you're not hearing about Q3 GDP and the craziest damn economy you ever saw" October 27, 2022).
- So far, according to the Atlanta Fed's real-time tracker, Q1-2023 is going to extend the streak.
- *We're not saying all those rate hikes strengthened the economy. It probably would be stronger without them. But they sure haven't killed it, at least not yet, and we're now seven and a half months beyond the onset of the worst part of the cycle.*

Another way of framing the idea is to consider that, to have a recession, both of two pre-conditions are required. Both are necessary, and neither alone is sufficient.

- *First, a recession requires a shock*. Business cycles don't just die, they have to be killed. The Fed can certainly supply the lethal shock, and it has done so many times (such as the Volcker double dips of 1980 and 1980-1981). It can be an oil shock (such as 1974-1975). It can be a pandemic (such as 2020).
- *Second, a recession requires vulnerability*. When faced with a shock, the economy has to be fragile enough to be harmed by it (and not robust enough to withstand it). Vulnerability can come from excessive speculation (such as 2001). It can come from excessive credit and leverage (such as 2008-2009).
- *It's like the fable of The Three Little Pigs. The shock was the wolf. All three pigs had the same wolf, but not all their houses were destroyed – only the vulnerable ones.*
- *We think our wolf isn't really very strong. And we think our house is made of brick.*
- It doesn't seem to us that a fed funds rate of 5.25% maintained for a couple months, as the market now implies, is much of a shock.

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Dallas TX
214 550 2020
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]

- To be sure, the funds rate was raised to 5.25% in mid-2006 – and the Great Recession and Global Financial Crisis followed. But it stayed at 5-1/4% for over a year. And most important, the economy was extraordinarily vulnerable. It wasn't even a house of straw like in the fable – it was a house of cards precariously built on an unprecedented degree of leverage between households, banks and Wall Street. The opposite is true today, with *below-median households still flush with cash* from the pandemic stimulus era, and no signs of stress in the financial system (see "Data Insights: High Frequency Post-Virus Recovery Monitor" February 16, 2023).
- And today *a contractionary cascade of unemployment will be very difficult to get started*, with posted job openings 2.1 million *above* trend, and employment 3.9 millions *below* trend (see "Video: What you're not hearing about the recession signal in temporary payrolls" January 30, 2023).
- And yes, *inflation has peaked* (almost a year ago) and is heading lower. We fully acknowledge that this week's surprisingly hot CPI report fits in very neatly with the string of stronger-than-expected data – see "Video: What you're not hearing about today's CPI" February 14, 2023). We acknowledge this is part of an understandable frustration that inflation is surely not heading lower as quickly as anyone would prefer. It's like a headache. It takes time to build up, and time to go away (and one tends to be asymmetrically hyperaware of the latter). But *inflation is most definitely going away, which means we can rule it out as a source of recession risk*.

With inflation having peaked – by the best measures, almost a year ago (see "On November CPI – Inflation Definitively Peaks" December 13, 2022) – it's a missed opportunity for human well-being for the Fed to pursue a higher cycle-peak rate just because the economy is getting stronger, its goal being to keep it from getting stronger still.

But that's a long way from saying the Fed will cause a recession. They are not the same thing.

- *Based on the relative mildness and brevity of the market-implied path of the funds rate, and the robustness of the economy as revealed in the latest data, we completely rule out a hard landing*.

Bottom line

Surprisingly strong jobs, PMI, retail sales – and CPI – data have driven the market-implied path of the funds rate to new cycle highs, now showing two-and-a-half rate hikes by summer, and only one rate cut by next January. The old "good news is bad news" cliché doesn't capture the dynamic though: this is an equilibrium in which, while the funds rate is higher, the economy is no more vulnerable than it was before because it has gotten stronger at the same time. This may point to a return to a pre-GFC "old normal," as implied by the S&P 500 equity risk premium having mean-reverted to 2007 levels. Recessions require both a shock and

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