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TRENDMACRO LIVE!

On Powell's Shocking Testimony

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Donald Luskin

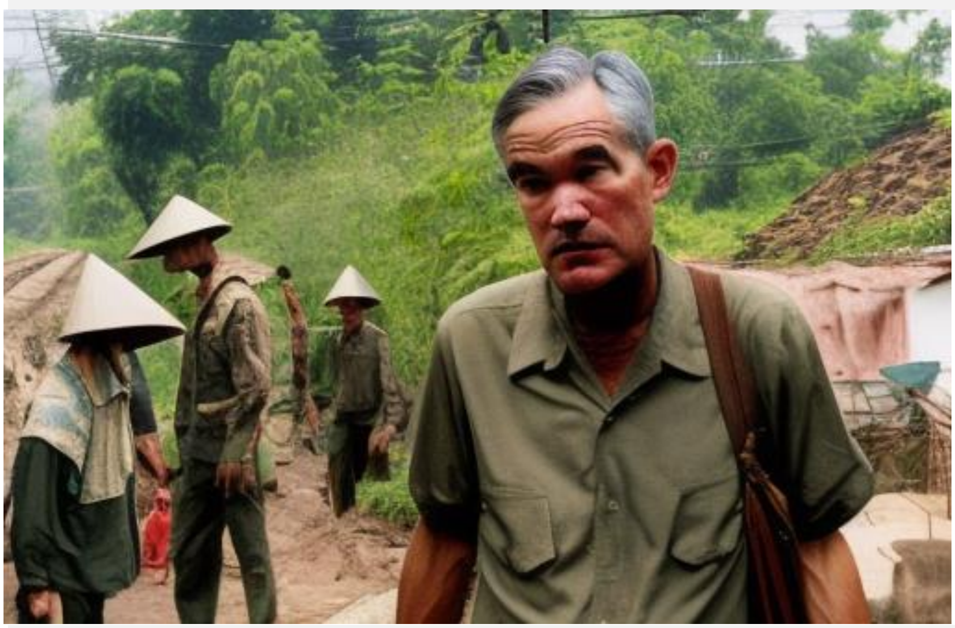
He's risking millions of jobs because an unpublished inflation index representing a minority of consumer expenditures isn't coming down as fast as overall inflation.

Chair Jerome Powell's testimony today as part of the Fed's Semiannual Monetary Policy Report to the Congress is scandalous – for its lack of transparency and for its policy inconstancy.

Powell acknowledges that "inflation has moderated somewhat since the middle of last year." Be he complains that "there is little sign of disinflation thus far in the category of core services excluding housing, which accounts for more than half of core consumer expenditures."

- He doesn't say why this half is more important than the other half. He says, "To restore price stability, we will need to see lower inflation in this sector…"
- And he's willing to inflict pain in order to achieve it. He continues, "… and there will very likely be some softening in labor market conditions." That's his cowardly way of saying he is willing to throw

Generative AI token: "Jerome Powell destroy the village to save it Vietnam, style of photojournalism"



Source: DreamStudio running Stable Diffusion 1.5

Update to strategic view

FEDERAL RESERVE, US MACRO: Powell says there is almost no disinflation in PCE core services ex-housing. The BEA does not publish a core services index, nor a core services index ex-housing, so markets and the public can't track what he says is the critical indicator for policy. He is wrong that core services represent more than half of expenditures. Based on CPI data, something like his preferred index peaked in September following the June peak in overall inflation, which since then has come down sharply. Based on all this he threatens to speed up the pace of rate hikes, and admits this will harm the labor market. Markets have built in an extra half rate hike in response, but are still expecting one cut by a year from now. Given the evident strength of the economy this is not likely a recession-triggering development. At this point, following five weeks of strong data, the expectations curve finally believes the Fed. Risks are now to the dove-side, which is to say that the worst is discounted.

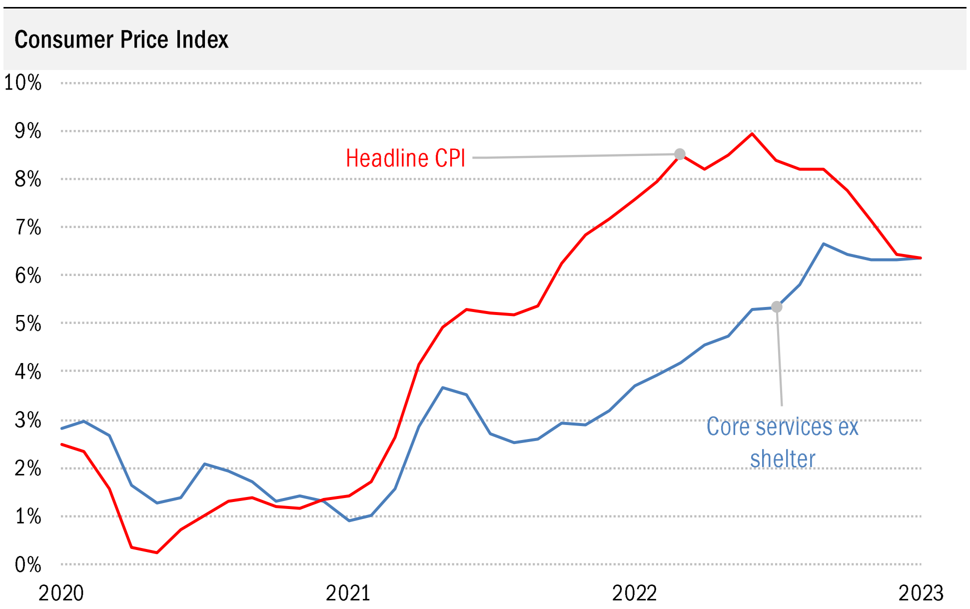
[Strategy dashboard]

millions out of work.

- And having wisely moved from 75 bp rate hikes to a more judicious 25 bp, he now says, "we would be prepared to increase the pace of rate hikes."

Powell is staking everything on an inflation index that isn't even published – so the markets and the public can't even observe what he claims is the most important variable.

- *The Bureau of Economic Analysis, which produces the Personal Consumption Expenditures Price Index data the Fed uses to measure inflation does not publish an index for "core services excluding housing." It doesn't even publish an index for "core services." And Powell doesn't even say what he means by "core services" to begin with.*
- We do know, though, that he is simply wrong when he says this unpublished index encompasses "more than half of consumer expenditures."
- Services are 66.5% of PCE. Of that, housing is 15%, so removing it leaves 51.5%. Energy services are 1.7%, which leaves 49.8%. We're already not "more than half' – that's less than half – and we haven't even taken out food services. We don't even know whether Powell was thinking of them when he said "core," but if he was, that's another 5.6%, reducing his preferred and unpublished index to only 44.2% of consumer expenditures.



Source: BLS, TrendMacro calculations

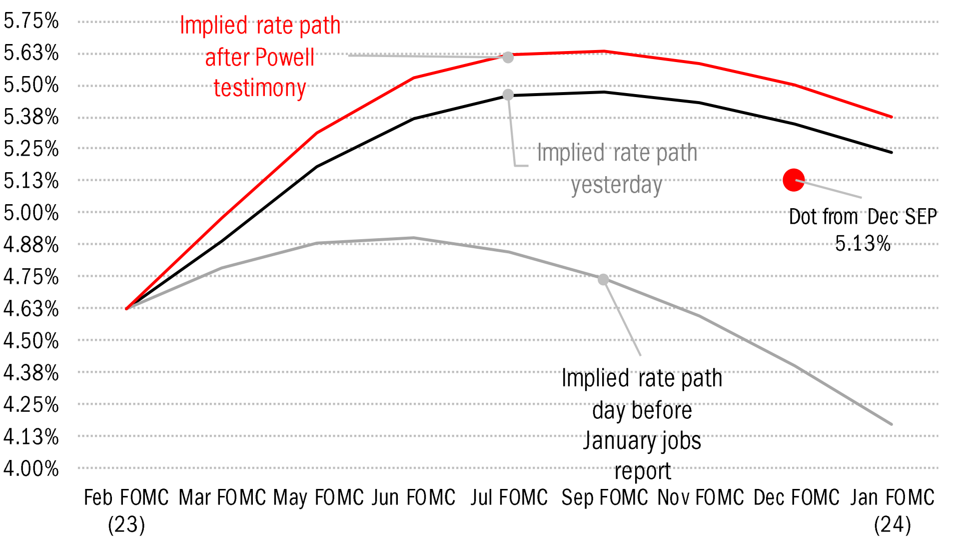
- The Bureau of Labor Statistics does publish a core services version of the Consumer Price Index, and we calculate with great precision what it would be if housing were excluded (please see the chart above, and "Data Insights: CPI/PPI" February 14. 2023).
- Core services ex-shelter index peaked all the way back in September, following the June peak in headline (which has

subsequently come down hard). *Why the special pride-of-place for what is, in fact, less than half the index? Why is its message of slow disinflation less valid than the majority's message of fast disinflation? And what's the right speed of disinflation anyway?*

- Powell doesn't explain any of this, but he does threaten to speed up the pace of rate hikes – presumably because a privileged minority of the index isn't coming down fast enough. Threatening to throw millions out of work for such a thing makes Powell like the man who complains his headache isn't going away fast enough after he took two aspirin – so now he's going to chug the whole bottle and poison himself. Except in this case Powell is going to poison everybody, "particularly African Americans and Hispanics," as the minutes of the February FOMC put it (see "Data Insights: FOMC Minutes" February 22, 2023).

There's no good news in this for markets. So it's noteworthy that, as of this writing, the reaction hasn't been worse. In particular, we note that the fed funds futures curve has only built an additional half rate hike into the expectations structure for the coming year – and *there's still one full cut expected by next January* (please see the chart below).

Fed funds futures



Source: Bloomberg, TrendMacro calculations

- Expectations have changed radically since the strong January jobs report just five week ago (see "On the January Jobs Report, and US Services PMI" February 3, 2023), and other strong macro data-points. This isn't necessarily a bad thing, as *the stronger data implies a stronger economy which implies a higher natural interest rate which, all else equal, calls for and can tolerate a higher funds rate* (see "Good News is Bad News is Equilibrium" February 16, 2023).
- And it's important that perhaps now, for the first time in this hiking cycle, expectations in the curve have finally started believing the Fed (see "Video: What you're not hearing about the day the market

stopped believing the Fed" December 19, 2022). It's only been for about two weeks that the expectations curve has set the implied December 2023 funds rate above, or even equal to, the "dot plot" put out at the December FOMC (see "On the December FOMC" December 14, 2022).

- That means the polarity of market fragility has reversed. The expectations curve that so doubted the Fed until the January jobs report was full of disappointment risk on the hawk-side. *With expectations having changed so much now, it looks to us like the risks are on the dove-side. Finally, the worst is probably discounted*.

Bottom line

Powell says there is almost no disinflation in PCE core services ex-housing. The BEA does not publish a core services index, nor a core services index ex-housing, so markets and the public can't track what he says is the critical indicator for policy. He is wrong that core services represent more than half of expenditures. Based on CPI data, something like his preferred index peaked in September following the June peak in overall inflation, which since then has come down sharply. Based on all this he threatens to speed up the pace of rate hikes, and admits this will harm the labor market. Markets have built in an extra half rate hike in response, but are still expecting one cut by a year from now. Given the evident strength of the economy this is not likely a recession-triggering development. At this point, following five weeks of strong data, the expectations curve finally believes the Fed. Risks are now to the dove-side, which is to say that the worst is discounted.