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FED SHADOW

FOMC Preview: Inflation (and First Republic) Collapse

Monday, May 1, 2023

Donald Luskin

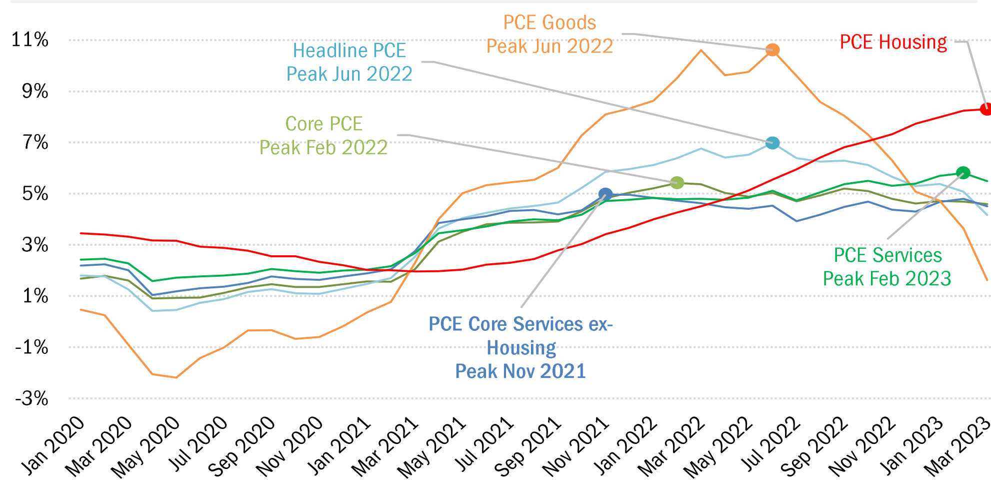
Goods inflation is already below the Fed's target, and another big bank has failed.

Markets give a 94% probability to a 25 bp rate hike at this Wednesday's FOMC, despite the collapse of First Republic Bank and its acquisition by JPMorgan Chase with FDIC financing and a loss-share agreement. We're on record saying March's hike was the last one, and we're prepared to be wrong. But there are *two good arguments* still to be made for our view. Yes, we know – this Fed never seems to listen to our good arguments.

First, inflation – the whole reason for this rate-hiking campaign in the first place – is collapsing.

- Friday's March Personal Consumption Expenditures inflation data – the measure the Fed prefers over the Consumer Price Index – shows *goods* prices up only 1.62% year-on-year (please see the chart below). Fed Chair Jerome Powell was panicked about that sector when it peaked at 10.61% in June, blaming the Russian invasion of Ukraine and supply-chain bottlenecks, and pulled the trigger on the first of four unprecedented back-to-back 75 bp rate hikes (see "On the June FOMC" June 15, 2022).
- *Now only nine months later, goods inflation – representing 33.5% of the consumption basket – is the first large sector to return to, and*

Personal Consumption Expenditures price indices, year-on-year



Source: BEA, TrendMacro calculations

Update to strategic view

FEDERAL RESERVE, US MACRO: Markets imply a 25 bp hike at Wednesday's FOMC, a pause in June, and then 4 rate cuts by January. With the failure of First Republic, we continue to think there's a chance of no hike Wednesday. We don't see why the FOMC would tighten the screws on banks that currently have borrowed $152 billion in emergency funds from the Fed already – or, for that matter, why the Fed would worsen its own negative net interest margin running now at $10.2 billion per month. On Friday PCE goods inflation, at 1.62% year-on-year, became the first major sector to achieve and move below the Fed's % target, having been at lmost 11% just nine ionths ago. On a 1-month nd 3-month basis, ervices and core services xcluding shelter are both elow 3%. The market-nplied path of rate cuts an be attained now vithout a hard-landing ecession to justify them, s the Fed changes ourse based on the ombination of bank stress nd collapsing inflation.

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go below, the Fed's 2% target.

- But Powell has switched to panicking about the other 66.5% of the consumption basket– services inflation, which didn't peak until last month (again please see the chart on the previous page). But it peaked at only 5.81% year-over-year, so it was never the emergency that the peak 10.61% in goods inflation was last year.
- *And goods inflation always leads. It led services inflation on the way up (when Powell was still saying inflation was "transitory"), and it will lead inflation on the way down (when Powell is still saying inflation is "sticky")*.
- *Indeed, PCE services inflation is now down to 2.8% and 2.5% on a 1-month and 3-month annual basis, respectively*. Target in sight.
- The most frustrating part is that Powell is now most closely focused on a subset of services inflation – "core services excluding shelter." Wall Street types like us who can juggle gigaton Excel spreadsheets or pay Bloomberg $2500 per month can view this index that our Fed chair now holds most sacred, but it is not made available to the public by the Bureau of Economic Analysis like the rest of PCE is.
- Besides the lack of transparency, this is annoying because this super-secret but all-important inflation gauge peaked – and at a mere 4.97% – all the way back in November 2021 (please again see the chart on the previous page). *Powell's complaint now is only that it isn't falling fast enough.*
- *Yet even this measure is now down to 2.9% and 2.4% on a 1-month and 3-month annual basis, respectively.*
- *Powell has become the Wrong-Way Corrigan of inflation forecasters*. It was less than two months ago that he testified before Congress that "inflationary pressures are running higher than

Generative AI token: "Goods inflation is already below the Fed's target, and another big bank has failed; style digital art"

Source: DreamStudio running SDXL Beta

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expected" (see "On Powell's Shocking Testimony" March 7, 2023). Instead, it would appear, they have collapsed.

Second, the banking crisis – it has now claimed another victim, First Republic, thanks to a Fed hiking regime that has already gone dangerously far.

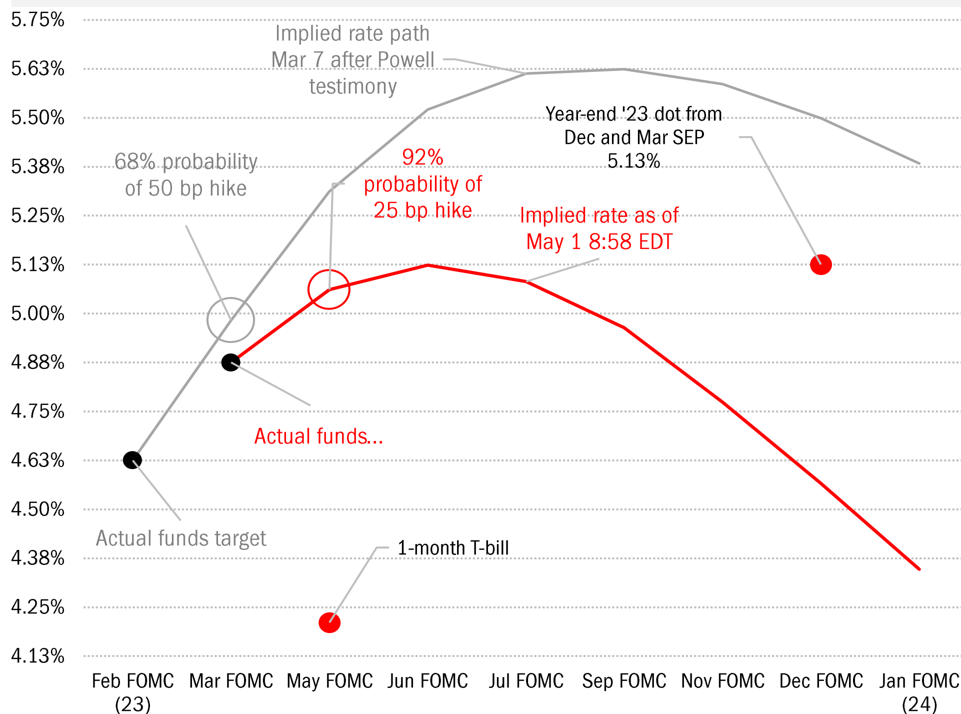
- On Friday the Fed published a hotly anticipated report by Vice Chair for Supervision Michael S. Barr, laying blame for the failure of Silicon Valley Bank (see "It's Over For SVB – And the Fed" March 13, 2023).
- In the press release announcing the report, blame goes *first* to SVB's management and board and *second* to the bank's regulators – including the Fed.
- Powell is quoted as welcoming this "thorough and self-critical report on Federal Reserve supervision." *Indeed he should, as there is not one single word blaming the totally gratuitous interest rate shock he himself administered after panicking about inflation nine months ago – an inflation that was about to collapse no matter what he did.*
- In the full report, a "rising rate environment" is mentioned as a critical situational variable, which the bank's management was especially inept (it says) at hedging against. But there's not a single word about the utterly unprecedented speed and magnitude of the Fed's rate shock and its historic impact on bank net interest margins, asset values and depositor behavior. No, the "rising rate environment" is treated as a natural phenomenon of no special note, arising for no particular cause nor from the action of any particular agent, like a crack in the sidewalk that any sensible person would just step over.
- *But this egregious after-the-fact ass-covering doesn't mean that the Fed doesn't know the truth. It doesn't mean the Fed has to hike rates again Wednesday, turning the screws on the approximately 4,300 banks that haven't failed yet, who collectively are now the recipients of $155.1 billion in Fed emergency loans.*
- *Nor for that matter should the Fed turn the screws on itself, considering that even at today's funds rate target of 4-7/8% its own net interest margin is negative to the tune of $10.2 billion a month* (see "The Fed is Silicon Valley Bank" April 17, 2023).

So now, with another bank dead, the Fed has every reason to be done, and with inflation collapsing, no reason not to be done. But it would seem there's going to be one more hike nevertheless.

- After all, the Fed did hike rates at the March FOMC, *after* Silicon Valley Bank and Signature Bank had already failed (see "On the March FOMC" March 22, 2023).
- Alan Greenspan would have cut rates, as he did three times during his historic tenure in response to three financial crises (see "FOMC Preview: The Meh-stro" March 20, 2023).
- At least the Silicon Valley Bank and Signature Bank failures did constrain the March FOMC to a mere 25 bp hike – after Powell had

warned of 50 bp a mere two weeks before (at the same time as he warned of those "higher than expected" "inflation pressures" – again, see "On Powell's Shocking Testimony").

- When Powell made that warning, the futures-implied policy path had pretty much taken a 50 bp hike on board for the March FOMC and was anticipating a peak funds rate at 5-5/8% in July (please see the chart below).



- Silicon Valley Bank failed three days after Powell's warning, and the March hike was only 25 bp. Again, there's another 25 bp expected Wednesday, but then that's all, folks. That's a cycle-peak rate at 5-1/8%, half a percentage point below what was expected less than two months ago (again, please see the chart above).
- Then a pause at the June FOMC, and then come the cuts – with the funds rate expected now to fall to 4-1/8% at the January 2024 FOMC, a full percentage point lower than the peak to be attained Wednesday, and three-quarters of a percentage point lower than today's rate.
- *We don't have any major differences with the market on this – but we still hold out a better-than-market chance that the Fed will pause Wednesday at 4-7/8%, rather than in June at 5-1/8%.*
- One can observe with great precision what markets like the money-market curve are thinking quantitatively, but who knows what their underlying narratives are? *For all we know, markets are forecasting immediate onset of a hard-landing recession – or a string of contagious bank failures – or both – that will force the Fed to cut.*

- But our rationale for a rate-path forecast similar to that of the markets is much happier.
- We can clearly see inflation rolling over. Especially with Friday's PCE update, the chances that the Fed will see it too are getting better and better.
- We don't see a further contagious banking crisis, but the failure of First Republic makes the *risk* of one more salient – which gives the Fed more incentive to forestall it by halting its hiking regime at a lower peak, which it will hold for a shorter time, and then initiate multiple rate cuts restoring policy to normal.

Bottom line

Markets imply a 25 bp hike at Wednesday's FOMC, a pause in June, and then 4 rate cuts by January. With the failure of First Republic, we continue to think there's a chance of no hike Wednesday. We don't see why the FOMC would tighten the screws on banks that currently have borrowed $152 billion in emergency funds from the Fed already – or, for that matter, why the Fed would worsen its own negative net interest margin running now at $10.2 billion per month. On Friday PCE goods inflation, at 1.62% year-on-year, became the first major sector to achieve and move below the Fed's 2% target, having been at almost 11% just nine months ago. On a 1-month and 3-month basis, services and core services excluding shelter are both below 3%. The market-implied path of rate cuts can be attained now without a hard-landing recession to justify them, as the Fed changes course based on the combination of bank stress and collapsing inflation.