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

MACROCOSM

As Inflation Collapses, the Fed Clings to The Big Lie

Thursday, November 30, 2023

Donald Luskin

They keep saying growth causes inflation (the opposite is true). But they aren't acting on it.

This morning's Personal Consumption Expenditures inflation data for October – headline at 0.6% and core at 1.98% at an annual rate – should be no surprise, although both beat estimates (see "Data Insights: PCE Inflation" November 30, 2023). It's based on the same underlying price survey data as the Consumer Price Index that reported similarly benign numbers two weeks ago (see "Data Insights: CPI/PPI" November 14, 2023).

- PCE is always special, though, because it is the Fed's preferred inflation gauge. And nested within it is Chair Jerome Powell's personal inflation measure – one that isn't officially published, but which we can calculate – core services excluding housing – aka "supercore" – which came in this morning at a very benign 1.73% at an annual rate.
- There will be another CPI report on December 12, the day before the FOMC meeting on December 13. With November wrapped up today, we can say for certain that report will show the second consecutive month of approximately zero inflation, or even some deflation (the Cleveland Fed's real-time estimator says -0.1% and Truflation, believe it or not, says -7.7%).
- There's just no way the Fed raises rates at the December FOMC – or ever again in this cycle, for that matter. That's the revealed behavior with two "pauses" at the September and November FOMCs, when the available inflation data was good, but not as drop-dead excellent, indeed deflationary, as it is now. That means this scorched-earth tightening cycle will have ended at the July FOMC, 5-1/4% in hikes over 16 months.

We're quite sure of this forecast now, even though we've been too early making it. And the money-market curve doesn't disagree. The only question now is when the first cut comes. *The curve now says the May FOMC for sure*. We say March, because the two back-to-back no-inflation/slight-deflation months we will have under our belts in two weeks point perfectly to the outright deflation we have warned you all year to expect at about this time (see, first, "Surprises of 2023 Volume 1: From Inflation to Deflation" January 3, 2023). *The Fed just has to react to that as it materializes and enters the public narrative*, as it is just now subtly beginning to do (see "On Wal-Mart's Deflation Call" November 16, 2023).

Update to strategic view

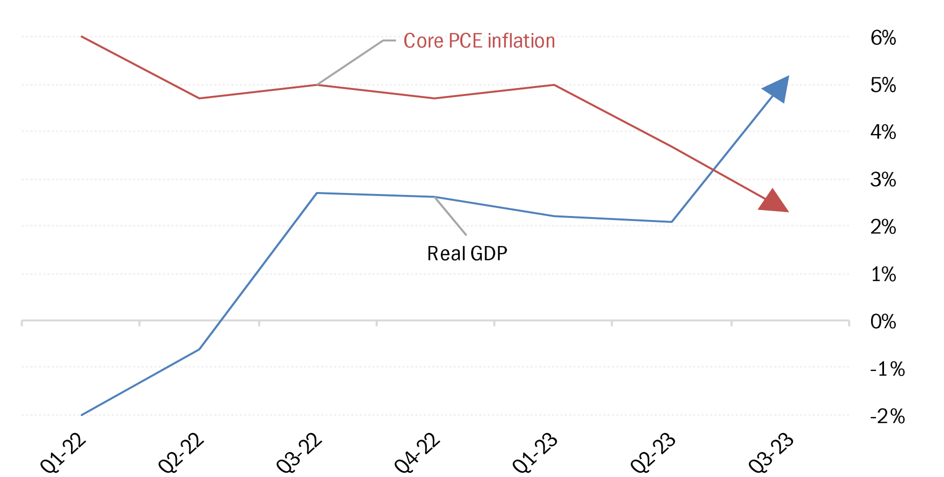
US MACRO, FEDERAL RESERVE: This morning's October PCE data matches CPI two weeks ago: inflation has rolled over. Yet the Fed, in speeches such as Waller's on Tuesday, continues to fear that strong economic growth represents an ongoing inflation risk. But inflation has collapsed from last year's peak (when growth was slow) to today's near-target readings (while growth is fast). This has been the pattern since the trough of the 2020 recession, and over the life of the data of more than 60 years. The theory the Fed treats as an axiom not only doesn't show up in the data, the opposite does. As the Fed continues to promote this Big Lie, they haven't acted on it – pausing across the last two FOMC meetings amidst surging Q3-2023 growth. They are using a self-evidently false narrative to keep markets on tenterhooks. But October inflation data points to deflation, and November's data reported before the December FOMC will confirm it. By March, deflation will be in evidence, and the Fed's narrative will have to change to preserve credibility. The first rate cut comes in March.

<u>But with this Fed, who knows?</u> They are so utterly unprincipled and inconsistent in their conceptualization of inflation and what causes it, *<u>we are learning never to assume they will let themselves be persuaded by mere facts</u>*.

Consider the speech Tuesday by Fed Governor Christopher Waller, who has been the most consistent and insistent among the hawks on the Board.

- He begins by acknowledging the fact that "we were observing strong economic growth and employment data in the third quarter, while simultaneously seeing a clear moderation in core personal consumption expenditures (PCE) inflation." That's putting it mildly. Real GDP grew at a blistering 4.9% at an annual rate, while core PCE inflation was a mere 2.3% at an annual rate, basically back to the Fed's 2% target.
- *<u>That's an impossible paradox for Waller, who believes that accelerating growth causes accelerating inflation</u>*. So now, with fourth quarter real growth estimated at something like 2%, Waller says, "I am encouraged by what we have learned in the past few weeks – something appears to be giving, and it's the pace of the economy." *<u>Yes, he said that</u>*. He is "encouraged" that the opportunity for people to earn wealth and well-being has been diminished.
- Waller prefers slower growth because in his mind, "If it did not cool off, then it was likely that progress on inflation would stop or even reverse."
- *<u>This is a classic case of cognitive dissonance – the facts don't comport with one's priors, so the facts (not one's priors) must be wrong</u>*.
- But it's not just one anomalous quarter in which accelerating growth was paired with decelerating inflation. It's been that way for the

Core Personal Consumption Expenditures price index, QOQ at annual rate, SA



Source: BEA, TrendMacro calculations

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

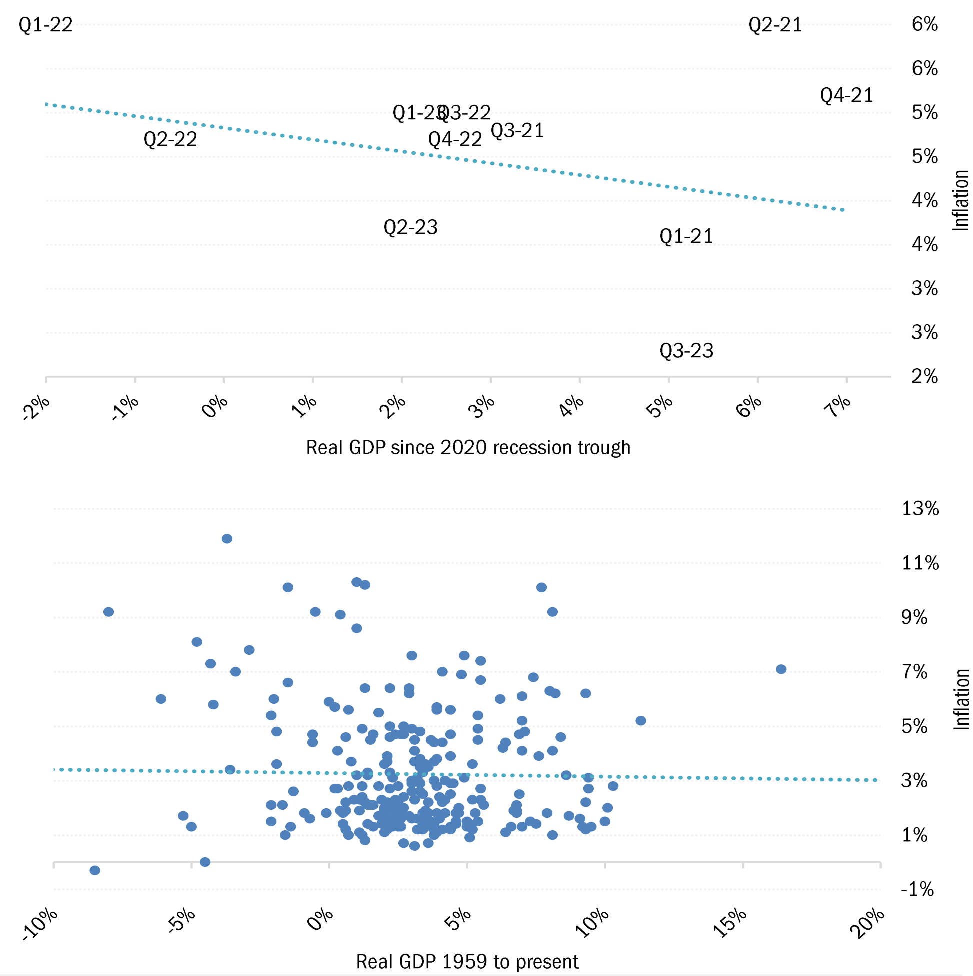
Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

whole business cycle expansion since the bottom of the Covid lockdown depression in 2020 (please see the chart on the previous page).*<u>The relation of growth and inflation has been, in fact, the opposite of what Waller claims: faster growth, lower inflation</u>*.

- This is borne out in a more rigorous statistical framework, in which the regression of quarterly data shows strongly negative correlation since the 2020 trough – that is, faster growth is associated with decelerating inflation, and slower growth is associated with accelerating inflation (please see the top chart below).
- It's not just the unusual post-pandemic economy, either. It's the same for the entire life of the data, beginning in 1959 (please see the bottom chart below).

Core PCE price index vs real GDP, QOQ at annual rate, SA



Source: BEA, TrendMacro calculations

- This makes Waller's speech – which only articulates a cause-and-effect narrative that we hear all the time from virtually every Fed official – nothing less than astonishing. *<u>The narrative is arrogantly repeated as a fundamental axiom, over and over, yet it does not show up in the data – indeed, the opposite does. It is a Big Lie</u>*.
- You'd think the Fed would have learned this once and for all after the slow-growth/high-inflation 1970s gave way to the fast-

growth/low-inflation 1980s (for more on that, join us for tomorrow's 1 pm ET Zoom conference call for clients with Jennifer Burns, author of the new best-selling biography of Milton Friedman, the monetary theorist who had so much to do with turning the awful 1970s into the brilliant 1980s).

- But no lesson learned, apparently.
- Clinging to this false narrative means the Fed's program now is to cause a recession in order to suppress inflation – with all the sacrifices of well-being that entails – when there is, in fact, not one shred of empirical evidence that it has ever worked (but we do know for sure that recessions impose terrible costs on people).

With all that said, *it should be easy to predict what the Fed will do here: unless there is evidence of impending or actual recession, the Fed will keep policy "restrictive."* Given our long-standing (and, so far, correct) outlook that there will be no hard landing, no soft landing, indeed no landing at all, the Fed may be done raising rates but there's no reason to think they will ever cut them.

But wait. It's not that simple, because the Fed's logic is apparently even crazier than that.

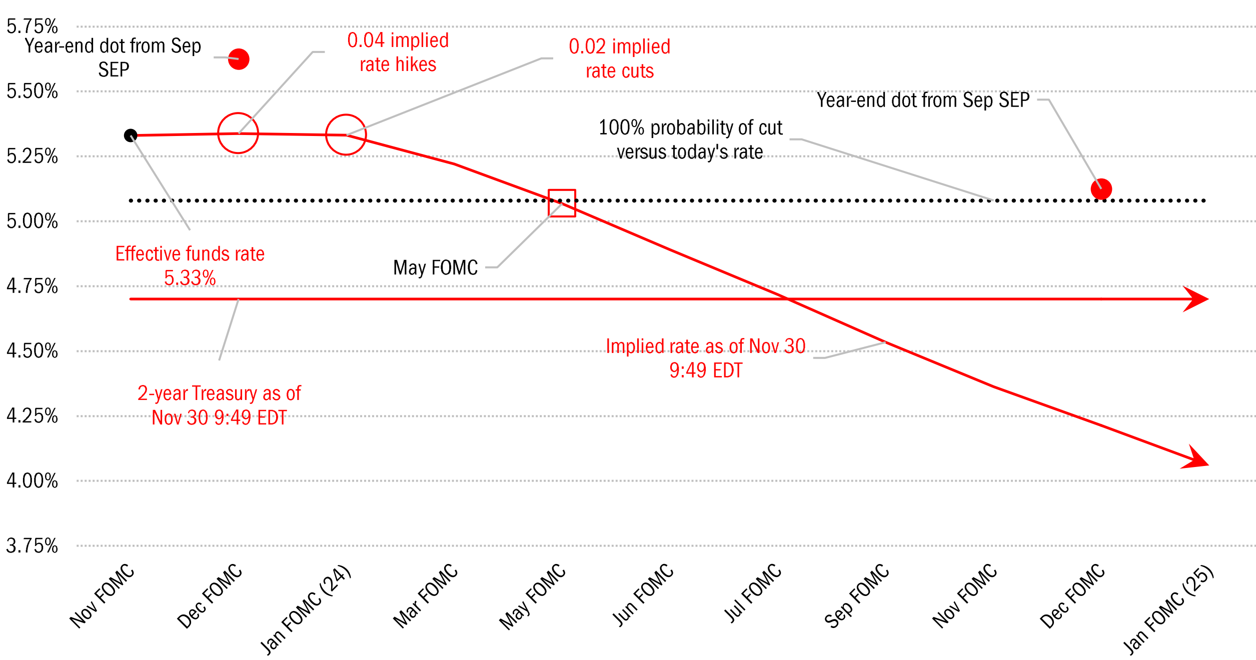
- Perhaps, in some sense, the Fed doesn't really believe the Waller narrative (after all, by the evidence, it is flatly not believable). Maybe they just say it, but they don't mean it.
- There is some strong recent evidence for that. After all, the FOMC "paused" at the September and November meetings, the two meetings at which it was obvious (from such sources as the Atlanta Fed's GDPNow) that third quarter growth was surging.
- In fact we interpreted the language changes in the November FOMC statement as especially dovish – despite Powell's obstinate hawkishness in the post-meeting presser – as deliberately downplaying third quarter growth as a decision factor (see "On the November FOMC" November 1, 2023).
- If accelerating growth were such an inflation risk, why would they pause across those two meetings – settling for rhetorical gestures like aggressively raising the "dot plot" for year-end 2024 at the September FOMC Summary of Economic Projections (see "On the September FOMC" September 20, 2023)?

So what are we to make of the fact that Fed officials sanctimoniously repeat an economic narrative that is flatly refuted by even the simplest evidence – yet, over the last two FOMC meetings, have acted contrary to that very narrative?

- *We must conclude that the Fed believes there is some expectations channel in operation, in which inflation can be suppressed by keeping markets on tenterhooks* as to how long the Fed will stay "restrictive" despite obvious evidence that last year's inflation threat has completely receded.

- We could square the circle by arguing that injecting such uncertainty into markets is itself a form of tightening – after all, it keeps market-determined rates higher than they would be otherwise, and thus arguably reduces the growth potential of the economy (and the Fed believes, wrongly, that growth causes inflation).
- Or, more cynically, we might conclude that the Fed is embarrassed by the all-too-evident refutation of their narrative, and out of some misguided desire to preserve what's left of their credibility, continues to articulate the narrative even while failing to act on it.
- That means the question going forward is: what will the Fed do to preserve its credibility over the next several months as the inflation they pretend still exists manifests as outright deflation?
- Our best guess is that they will cover themselves in laurel leaves as they declare their courageous victory over inflation (without causing even a soft landing) – which means they will likely lower the 2024 "dot plot" at the December SEP, signaling that policy need no longer be "restrictive" for so long.
- But how long? Again, markets think the first cut will come for sure at the May FOMC (the curve is implying a 2% probability, and a 45% probability for March – please see the chart below). But by then, deflation should have already been in evidence for several months, and the Fed will have a different credibility crisis. By the March FOMC there will be four more CPI reports in hand. Maybe it's slicing the baloney too thin to quibble with the market's May forecast – and to be sure, this is an exercise in mind-reading officials whose minds strike us as particularly dysfunctional and

Futures-implied effective fed funds rate, by FOMC meeting



Source: Bloomberg, TrendMacro calculations unpredictable right now. But we think the Fed will have begun to panic by March. That's when the cuts will begin.

Bottom line

This morning's October PCE data matches CPI two weeks ago: inflation has rolled over. Yet the Fed, in speeches such as Waller's on Tuesday, continues to fear that strong economic growth represents an ongoing inflation risk. But inflation has collapsed from last year's peak (when growth was slow) to today's near-target readings (while growth is fast). This has been the pattern since the trough of the 2020 recession, and over the life of the data of more than 60 years. The theory the Fed treats as an axiom not only doesn't show up in the data, the opposite does. As the Fed continues to promote this Big Lie, they haven't acted on it – pausing across the last two FOMC meetings amidst surging Q3-2023 growth. They are using a self-evidently false narrative to keep markets on tenterhooks. But October inflation data points to deflation, and November's data reported before the December FOMC will confirm it. By March, deflation will be in evidence, and the Fed's narrative will have to change to preserve credibility. The first rate cut comes in March.