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MACROCOSM

Sticky Inflation? Or Sticking the Landing?

Tuesday, March 12, 2024
Donald Luskin

There's no risk of resurgent inflation. But where's the deflation that should be here now?

February headline *CPI came in at consensus expectations* this morning at 0.4% on the month and 3.2% year-on-year; *core missed*, at 0.4% on the month (0.3% expected) and 3.8% year-on-year (3.7% expected). That would seem to not be much progress on giving the Fed the "evidence" it says it needs that inflation is headed back to target. What's worse, both headline and core appear to be "accelerating," in the sense the month-on-month growth is higher then three-month annual, which is higher than year-on-year (see "Data Insights: CPI/PPI" March 12, 2024).

Yes as of this writing *the stock market doesn't seem too worried*. Why not?

- Surely at least in part it's because *markets have started agreeing with us that it doesn't matter exactly when Fed starts cutting rates*. Indeed, they are acting like the present funds rate isn't "well into restrictive territory" at all, despite the Fed's repeated claims to that effect (see "Video: What you're not hearing about why it doesn't matter when the Fed cuts rates" February 26, 2024)
- And as to what amounts to mere technical analysis showing inflation "accelerating," the reality is that *just five items* – gasoline, owners' equivalent rent, transportation services, rent of primary residence and airline fares – *exactly explain the entire month* (again, see "Data Insights: CPI/PPI"). *Without these five items from among 180, CPI would have been unchanged for the month of February*.

Our preferred measure of inflation, core excluding owners' equivalent rent of residences, came in at 2.41%. The Fed's 2.0% target for Personal Consumption Expenditures inflation, translated into CPI-equivalent terms, is 2.5%. *Core ex-OER has now been below that target level for six months running*.

So if the fear here is that inflation is proving to be "sticky" after all, that should actually be a good thing, because it is sticky slightly below the Fed's target. *That's not sticky in any bad sense – that's the Fed sticking the landing*.

- We have been forecasting that outright deflation would materialize because of the lagged effects of the contraction in the money

Update to strategic view

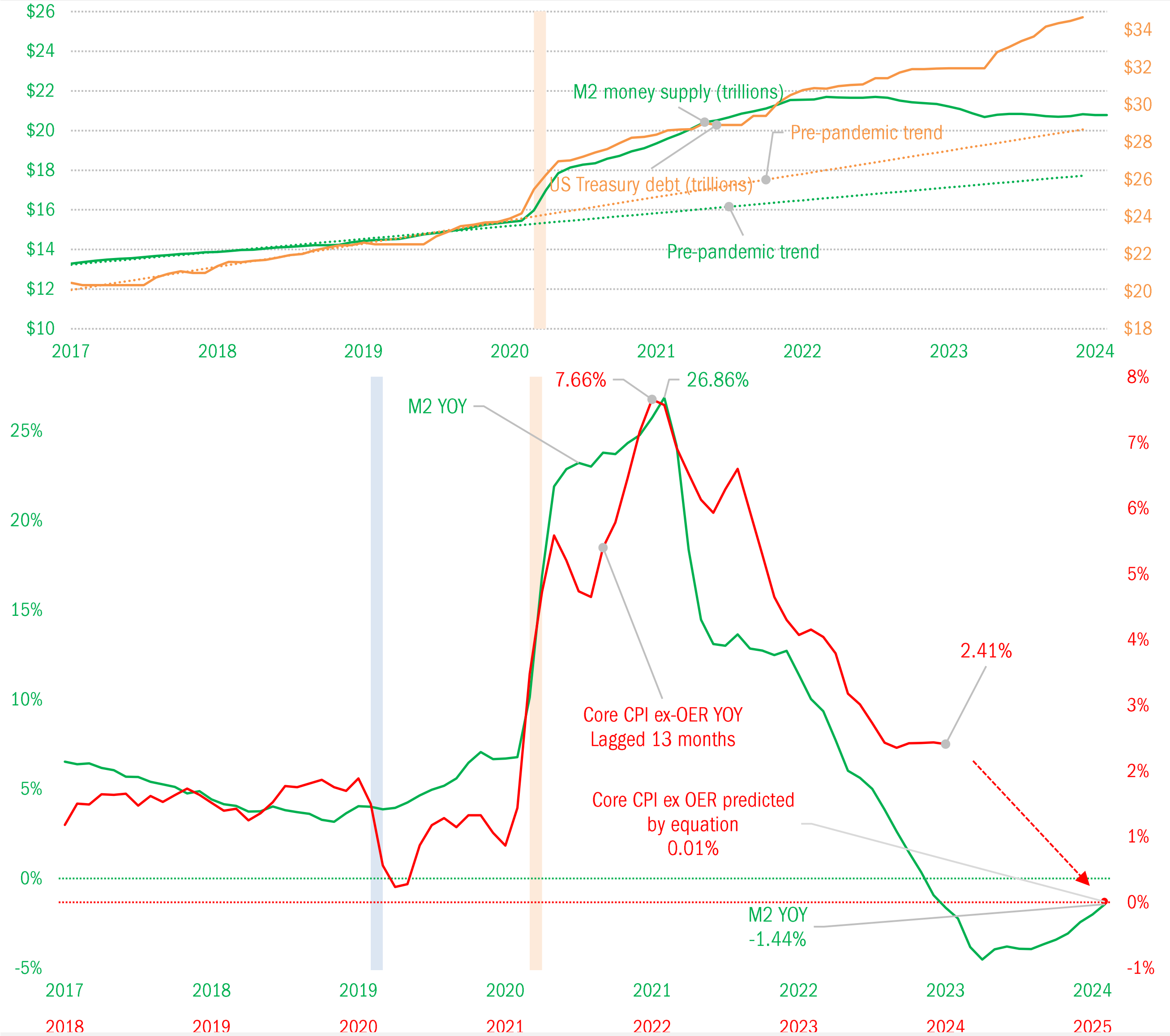
US MACRO, FEDERAL RESERVE, US STOCKS: Headline CPI came in at expectations, core missed – and both show "acceleration." The stock market is treating it as good news. Just five items out of 180 explain the entire month's inflation. Core ex-OER is now below the Fed's target for sixth months. If inflation is proving to be "sticky," it is sticky below the Fed's target. The deflation we have been predicting should have materialized by now, but so far it is restricted to the goods components of the CPI. Our model based on the money supply remains conceptually compelling and statistically robust, but it has failed to call deflation with the pinpoint accuracy with which it called the top in inflation. As the absolute magnitude of changes in M2 falls, even though the changes are negative, the model becomes more noisy. We think deflation would be good for growth, but markets fear it. So with the risk of deflation fading, no risk of resurgent inflation, and increasing comfort that the Fed is not very restrictive, there is a very strong background for stocks.

[Strategy dashboard]

supply (see, among many, see [“Inflation Has Peaked -- Get Ready for Deflation”]() May 24, 2023).

- We have long forecasted that markets would experience a triumphal blow-off top to celebrate the conquering of inflation without so much as even a soft landing. *That’s looking like nothing short of brilliant prediction, if we do say so ourselves.*
- But then again we also said that deflation would emerge, and markets would panic when it did, even though a gentle deflation would in fact be a useful restorative after the sharp inflation we’ve experienced. *That isn’t looking like a similarly brilliant prediction.*
- *Our deflation just isn’t emerging, at least not in headline CPI or PCE. According to our model* (please see the chart below), *it should have by now. And with the contraction in the money supply having decelerated considerably from last year’s scary clip, our*

Relation of Treasury debt, M2 money supply and core CPI (ex OER), and TrendMacro’s monetarist inflation prediction model



Source: TrendMacro calculations

model is now saying that CPI will go positive again 13 months from now (having so far not gone negative).

- Purely as a statistical matter, our model is still showing the same extraordinarily strong coefficient of determination (r-squared) as it always has. But an r-squared of 0.9 isn't 1.0 – and even if it were, that is measuring the past and not assuring the future. And as the monthly variances in the money supply and the Consumer Price Index fall from their historic peaks in 2020 and 2021, the signal they generate becomes increasingly dominated by noise.
- *So the reality is that the model that called the top in inflation to the very month is starting to trip up in calling a deflation that should have materialized by now, but hasn't.*
- It may yet. Inflation in goods – which comprise 36% of the CPI basket – has already been below the Fed's target on a year-over-year basis for every one of the last twelve months, of which three were downright deflation.
- It may be that all that's wrong with the model is the lag from change in money supply to change in the price level. We may just have to be patient for the deflation in goods – which are the high-beta leading parts of inflation – to filter into services – which are the low-beta lagging parts.
- But then again we mock those who are still, almost two years later, waiting for the lagged effect of the inversion of the yield curve. We need to be appropriately humble here – our deflation forecast should have started showing up more already, and it hasn't.
- Whether or not it comes, we still think deflation would be a good thing for the economy after the shock of the worst inflation in forty years. But markets might not feel the same way.
- In November, Walmart's earnings report emphasizing the onset of deflation in their pricing structure took 7% off its stock price (see "On Walmart's Deflation Call" November 16, 2023), despite management's arguments that it was a good thing. In the following most recent quarter, management significantly softened the deflation call, and now the stock is at all-time highs.

Conceptually, our model based on changes in the money supply remains very compelling. We are respectful of the apparent diminution of pin-point predictive power as changes in the money supply, though negative, become lower in absolute magnitude and thus more subject to month-to-month noise. So *it becomes harder for us to pound the table about deflation – but we remain evangelically convinced there is no possibility of a resurgence of inflation with the money supply in contraction*. Less risk of deflation, no risk of recurring inflation, and increasing acceptance that the Fed is not in fact very restrictive would appear to be a very strong background for the stock market.

Bottom line

Headline CPI came in at expectations, core missed – and both show "acceleration." The stock market is treating it as good news. Just five items out of 180 explain the entire month's inflation. Core ex-OER is now below

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[About us]

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