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MACROCOSM

Has the Economy Become Inflation-Prone?

Wednesday, October 9, 2024

Donald Luskin

It's a question, not a forecast. But for what it's worth, our model is saying it has.

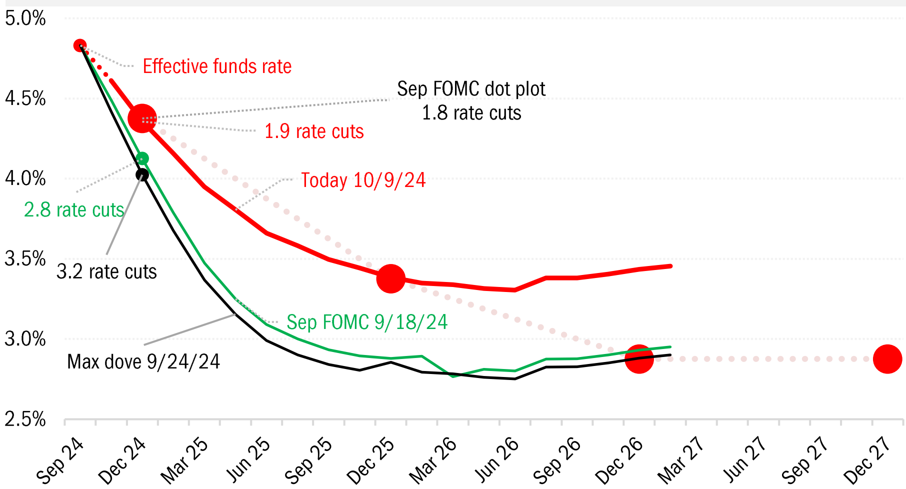
As we head into tomorrow's release of September CPI data, we are somewhat concerned that there will be miss, just when the Fed has said it has "growing confidence that with an appropriate recalibration of our policy stance, strength in the labor market can be maintained in a context of moderate growth and inflation moving sustainably down to 2 percent" (see "On the September FOMC" September 18, 2024).

- The consensus says headline CPI for September will be 0.10%. The Cleveland Fed's "nowcast" says 0.11%. But the Truflation real-time model says 0.40%, which would be quite a miss (see "TrendMacro conversation on Truflation, with co-founder and product lead Oliver Rust" December 21, 2023).
- We have found Truflation to give good indications of direction – that is, beat or miss – but not magnitude. So we are not expecting the whopper miss that 0.40% would represent – but there's a decent chance there will be some miss.
- *That matters because market expectations for Fed rate cuts have already come in considerably – with the curve having moved from expecting 3.2 cuts by year-end just two weeks ago to now expecting only 2 cuts* (please see the chart below). *As of this*

Update to strategic view

US MACRO, FEDERAL RESERVE: We fear a miss in tomorrow's CPI, with the consensus expecting a very light 0.1%. Expectations for Fed rate cuts by year-end have already come in considerably, with only an 85% probability of a November cut – based on a new consensus that there will be no recession. Beyond the noise of a single data-point, we have to ask why our monetarist model is now forecasting CPI to keep rising over the coming year from below the Fed's target, where it is now, eventually to exceed the Fed's target – even though the money supply is growing at a paltry 2% year-over-year? For that matter, why didn't deflation materialize when the money supply had it's first-ever contraction in the history of the data. Is the economy more inflation-prone now for some reason? If so, a candidate explanation is ongoing fiscal stimulus, but that hasn't been large enough to show up in money supply growth. Rising velocity isn't a likely answer, because it has recovered from its pandemic trough only back to a long-standing secular downtrend.

Fed funds rate path by FOMC meeting



Source: Bloomberg, FRB, TrendMacro calculations *writing, the future markets assign only an 85% probability to any cut at all at the November meeting.*

- That shift in expectations, we think, is the result of a sudden capitulation of the consensus to our long-standing no-recession call (see, for example, "Sprott Debates #2 - David Rosenberg & Don Luskin" October 8, 2024), seemingly triggered by nothing more than a surprisingly good jobs report last week (see "On the September Jobs Report" October 4, 2024). And two cuts by year-end is what the Fed's "dot plot" told markets to expect anyway (again, please see the chart on the first page and, again see "On the September FOMC"). The curve also perfectly mirrors the "dot plot" for year-end 2025. It's because the Fed doesn't need to cut as aggressively if imminent recession is ruled out.
- But if now doubt is cast on the "confidence" the Fed should have that disinflation is continuing "reliably" – and considering that the Fed and many economists falsely believe growth causes inflation, *a CPI miss tomorrow could be unsettling to markets for a bit*.

But looking beyond what is likely mere noise from a single data release, there is a potentially a deeper issue.

Our monetarist model of inflation – explaining it as the lagged result of growth in the M2 money supply (please see the chart below) – afforded a

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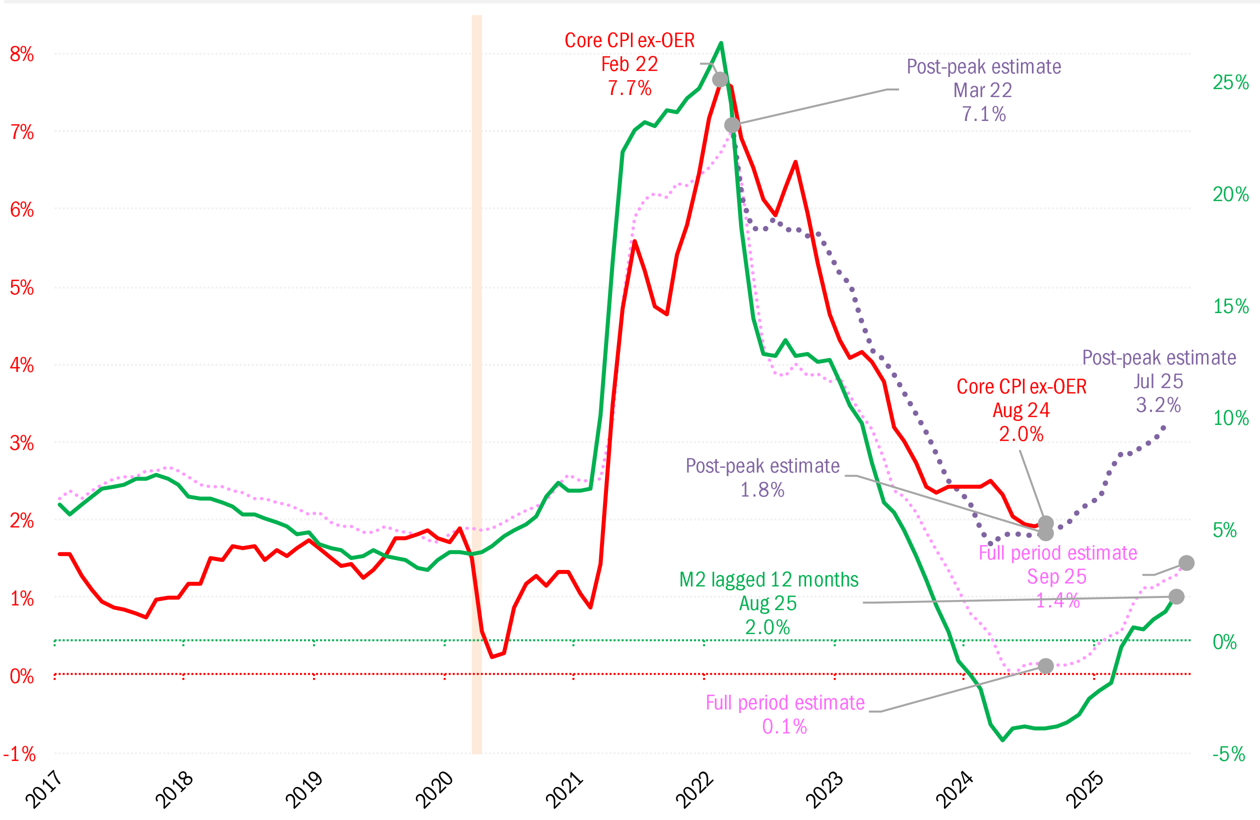
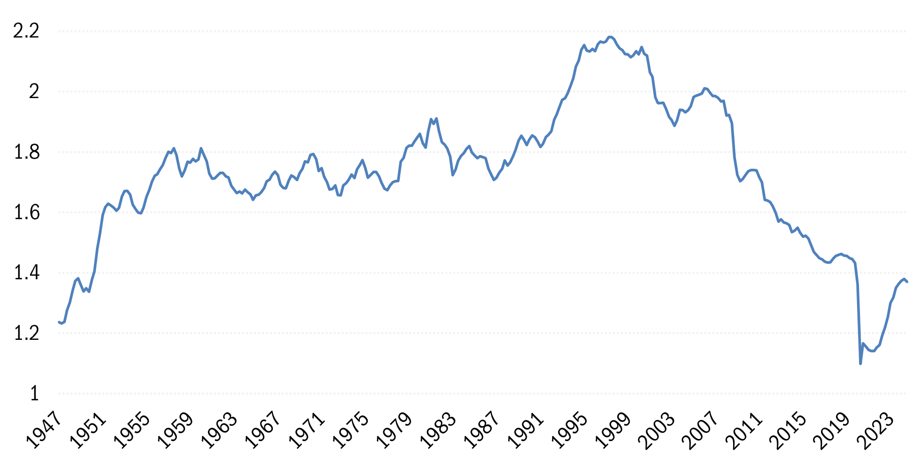


Source: BLS, FRB, TrendMacro calculations literally perfect forecast of the top in inflation in 2022, just when the consensus had become convinced it was very much not transitory, indeed permanent (please see the chart below and, among many, [“Why Inflation Is on the Way Down”]() July 25, 2022). The same model predicted outright deflation as money supply growth first returned to normal and then contracted for the first time in history (see, among many, [“Inflation Has Peaked -- Get Ready for Deflation”]() May 24, 2023). *But unlike our great call for the top in inflation, the call for deflation was wrong – instead, we’ve had only a consistent disinflation (without a recession), with deflation confined to the goods sector.* We retracted our deflation call in April, and adjusted our model (see [“Video: What you’re not hearing about the shrinking money supply and the prospect of deflation”]() April 24, 2024).

- But that leaves troubling questions.
- In the chart on the previous page (showing the relation of M2 growth to core CPI inflation excluding OER), our original deflation forecast is the light pink dotted line labeled “Full period estimate” (it is called that because it uses all the data in the timeframe viewed). According to that original version of the model – the one that called the top perfectly – inflation should now be only 0.10% year-on year, having just come out of a slight outright deflation.
- *How can we have had the only contraction in the money supply in the modern history of the data and not gotten deflation as a result?*
- The revised forecast is the heavier purple dotted line, called “Post-peak estimate” (because it looks at data only since the 2022 peak in inflation). At 1.8% year-on-year, it perfectly predicted inflation as of the most recent data, at 2.0%.
- *Now that the money supply is growing again – but a mere 2% year-on-year, less than half the historical average before the pandemic – why does our revised model call for inflation to have bottomed, and now to gradually creep up back to an above the Fed’s target?*

Monetary velocity, derived from [the Equation of Exchange]()



Source: Bloomberg, TrendMacro calculations

- *Has the economy become inflation-prone, if a sharp contraction in money fails to cause inflation, and sluggish money growth is pointing to higher inflation?*
- In conversations with clients about this, we've heard many potential narrative answers.
- *We are often asked if ongoing fiscal stimulus is responsible*.
- Maybe… but if it doesn't show up in money growth, how can it be, at least within the monetarist framework of the model?
- *We have also been asked about monetary velocity*, which plunged during the pandemic and has since recovered. Velocity – the number of times a given money-stock is turned over in transactions in the economy in a given time period – is effectively a money supply multiplier.
- But the collapse of velocity was associated with short-lived deflation during the pandemic, and its recovery has been associated with disinflation (please see the chart on the previous page). And that recovery has only restored velocity to its secular downtrend that began in the mid-1990s.
- The simplest answer is that our simple regression model is just a simple regression model – and it works well when the independent variable driving it has a large value, and less well when it has a small value. In other words, it had a high signal-to-noise ratio in 2021 and 2022 when it called the top – but a low ratio now, in which case maybe we shouldn't even care what it says.
- Be that as it may, it is at least harmonious with our idea that this Fed easing cycle, absent a recession, is highly unlikely to go the 2-3/4% funds rate suggested now by the "dot plot." In a world of higher growth – and all the more in a world that might be more inflation-prone for some reason – the neutral rate is surely higher than that (see, among many, "FOMC Preview: A Political Decision?" July 29, 2024).
- Amazing, while the money market curve became much more dovish than the Fed after the September FOMC – but has now come to conform perfectly with the "dot plot" for 2024 and 2025 – note that the curve is substantially more hawkish than the Fed for 2026 (again please see the chart on the first page). We think the curve is right and the Fed is wrong. We think we'll see the 2026 "dot plot" come up considerably over the next several Summaries of Economic Projections.
- If it's in the name of growth, markets will love it. If it turns out that our ruminations about a more inflation-prone economy are the reason – not so much.

Bottom line

We fear a miss in tomorrow's CPI, with the consensus expecting a very light 0.1%. Expectations for Fed rate cuts by year-end have already come in considerably, with only an 85% probability of a November cut – based on a new consensus that there will be no recession. Beyond the noise of a single data-point, we have to ask why our monetarist model is now forecasting CPI to keep rising over the coming year from below the Fed's target, where it is now, eventually to exceed the Fed's target – even though the money supply is growing at a paltry 2% year-over-year? For that matter, why didn't deflation materialize when the money supply had it's first-ever contraction in the history of the data. Is the economy more inflation-prone now for some reason? If so, a candidate explanation is ongoing fiscal stimulus, but that hasn't been large enough to show up in money supply growth. Rising velocity isn't a likely answer, because it has recovered from its pandemic trough only back to a long-standing secular downtrend.